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Scienter in Professional Liability Cases

John P. Freeman

University of South Carolina

Nathan M. Crystal

University of South Carolina

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SCIENTER IN PROFESSIONAL LIABILITY CASES

JOHN P. FREEMAN*
NATHAN M. CRYSTAL**

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* Professor of Law, University of South Carolina School of Law. B.B.A. 1967, University of Notre Dame; J.D. 1970, University of Notre Dame; LL.M. 1976, University of Pennsylvania.

** Associate Dean and Professor of Law, University of South Carolina School of Law. B.S. 1968, University of Pennsylvania; J.D. 1971, Emory University; LL.M. 1976, Harvard University.

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I. INTRODUCTION

As of March 1991 the Resolution Trust Corporation had taken control of more than 580 financial institutions, instituted suits against fifty-eight individual lawyers and law firms, and suggested that it might bring numerous additional suits over lawyer misconduct related to the failure of more than 140 thrift institutions.¹ The Federal Office of Thrift Supervision's general counsel has taken the position that professionals played key roles in facilitating the savings and loan industry's implosion: "Our own view is that few of the frauds and none of the high-risk schemes could have been undertaken without the active assistance of professionals, including lawyers and accountants."² In the same vein, a federal judge recently adverted to unanswered questions posed by the notorious Lincoln Savings and Loan debacle:

Keating testified that he was so bent on doing the "right thing" that he surrounded himself with literally scores of accountants and lawyers to make sure all the transactions were legal. The questions that must be asked are:

Where were these professionals, a number of whom are now asserting their rights under the Fifth Amendment, when these clearly improper transactions were being consummated?

Why didn't any of them speak up or disassociate themselves from the transactions?

Where also were the outside accountants and attorneys when these transactions were effectuated?

What is difficult to understand is that with all the professional talent involved (both accounting and legal), why at least one professional would not have blown the whistle to stop the overreaching that took place in this case.³

Professionals these days are not just the targets of rhetorical questions. Increasingly they are being forced into a role of the deep pocket of last resort.⁴ Civil suits against lawyers and accountants come in all

1. Schmidt, *Panel: "Where Were the Lawyers During S&L Crisis?"*, Wash. Post, Mar. 23, 1991, at B1, cols. 2-4.

2. *Id.*

3. *Lincoln Sav. & Loan Ass'n v. Wall*, 743 F. Supp. 901, 919-20 (D.D.C. 1990).

4. *E.g.*, France, *Savings & Loan Lawyers*, 77 A.B.A. J. 52 (1991) (mentioning the Kaye, Scholer law firm's payment of \$20 million in Keating-related litigation, noting an "avalanche of litigation" and forecasting that at least 100 more suits against counsel for failed thrifts were expected to be filed by the end of the year); Newdorf, *Ex-partners Targeted in S&L Cleanup*, Legal Times, May 27, 1991, at 10 (noting that in the government's \$1 billion civil fraud suit arising out of the Lincoln Savings and Loan collapse, the RTC, apparently for the first time, named a law firm's partners, including former partners, as class defendants; article also mentions an \$18 million settlement with Jenkins & Gilchrist, a Dallas law firm, relating to the failure of two thrifts); Granelli, *Law*

forms, from garden variety malpractice or fiduciary duty cases to more esoteric claims under statutes such as state deceptive trade practices acts.⁵ It is safe to say, however, that as a group no civil actions instituted against professionals are more feared than those premised on allegations of scienter, whether in the form of common-law fraud claims, aiding and abetting or conspiracy allegations, civil RICO or securities law violations, or some other species of claim built around scienter.

If proved, such scienter-based claims generate multiple problems for the defendant professional. For one, fraud-related damage awards may fall outside malpractice insurance policy coverages, which tend not to provide protection for fraud-related conduct.⁶ Civil fraud suits brought under the federal civil RICO statute⁷ or under rule 10b-5⁸ may

Firm Reaches Settlement in Lincoln S&L Case, L.A. Times, May 21, 1991, at pt. D, p. 7, col. 2 (mentioning that Chicago's Sidley and Austin law firm agreed to pay up to \$34 million to settle Lincoln-related class action claims). See also Greer, *CPA Firm Loses Big in Local Court*, Hous. Bus. J., Feb. 5, 1990, at sec. 1, p. 1 (reporting on entry of a \$37.7 million judgment, after a jury trial, against the now-bankrupt Laventhol & Horwath accounting firm based on their involvement in a Herman Finesod tax shelter "designed to profit Finesod and his accomplices at the expense of limited partner investors." The luckless accounting firm later settled the suit for \$13.5 million of which only \$4.4 million was covered by insurance.); Berton, *Bad Numbers: Laventhol & Horwath, Beset By Litigation, Runs Into Hard Times*, Wall St. J., May 17, 1990, at sec. 1, p. 1, col. 6.

5. Suits against lawyers under state deceptive trade practices statutes have been upheld by the Supreme Courts of Texas, Connecticut, and Massachusetts. See *Heslin v. Connecticut Law Clinic of Trantolo & Trantolo*, 190 Conn. 510, 461 A.2d 938 (1983); *Guenard v. Burke*, 387 Mass. 802, 443 N.E.2d 892 (1982); *DeBakey v. Staggs*, 612 S.W.2d 924 (Tex. 1981). The Montana Supreme Court has indicated that such a claim may exist. *Matthews v. Berryman*, 196 Mont. 49, 637 P.2d 822 (1981). The Illinois and New Hampshire Supreme Courts have rejected the notion. *Frahm v. Urkovich*, 113 Ill. App. 3d 580, 447 N.E.2d 1007 (1983); *Rousseau v. Eshleman*, 128 N.H. 564, 519 A.2d 243 (1986).

6. See, e.g., *Humphreys v. Niagara Fire Ins. Co.*, — Pa. Super. —, 590 A.2d 1267 (1991) (exclusion covering fraudulent or dishonest acts covered civil RICO allegations and supported insurer's decision not to provide a defense to such claims); *Lerman, Lying to Clients*, 138 U. PA. L. Rev. 659, 697 (1990).

7. 18 U.S.C. §§ 1961-1968 (1990) (Racketeer Influenced and Corrupt Organizations).

8. 17 C.F.R. § 240.10b-5 (1991). Adopted under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b)(1988), Rule 10b-5 makes it unlawful to use the mails or an instrumentality of interstate commerce:

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact, or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1991).

be framed as federal class actions that can result in massive liability.⁹ Other hazards are the risk of a heavy punitive damages award, which may be excluded from malpractice insurance coverage,¹⁰ as well as the possibility, if not the certainty, of ethical sanctions if a scienter-based judgment is entered.

Aside from the enhanced remedies that may accompany scienter-linked lawsuits, civil claims against professionals premised on scienter allegations present a major advantage for plaintiffs by allowing circumvention of the privity defense.¹¹ The bounds of professional liability for simple negligence, that is, honest blunders unaccompanied by proof of fraud, are still fairly narrow.¹² Thus, injured nonclients, such as victims of swindles made possible through professionals' services, have a great incentive to attack professionals with precisely the type of lawsuit that is the most fearsome. Indeed, in jurisdictions that circumscribe professionals' liability to nonclients for negligence, injured third parties may have no choice but to consider suing for fraud.

This Article explores the element of scienter, also called "intent," or "guilty knowledge," as it applies in litigation against defendant professionals. It examines scienter from three perspectives: what it is, how it needs to be pleaded, and how it can be proved. The discussion focuses on what scienter means at common law, under federal common law, and under criminal statutes. The discussion shows a tendency on the part of federal courts to slant the formulation of the scienter element in federal civil fraud in favor of professionals. Pleading requirements in federal civil fraud cases likewise are distorted in favor of the defense in civil cases against professionals. This Article suggests the theory of conscious avoidance as a means of counteracting undue judicial solicitude for professional defendants in civil fraud cases. The use of conscious avoidance as a means of proving knowledge or intent has been approved repeatedly in federal criminal cases prosecuted against participants in illegal schemes.

9. For a discussion of professionals' liability under the RICO statute, see Wright, *Why Are Professionals Worried About RICO?*, 65 NOTRE DAME L. REV. 983 (1990).

10. See J. SUTTON & J. DZIENKOWSKI, PROFESSIONAL RESPONSIBILITY OF LAWYERS 162 (1989) (noting that lawyer malpractice policies typically exclude coverage for punitive damages).

11. See Wright, *supra* note 9, at 985-88.

12. For a discussion of the differing positions taken on the privity issue, see Freeman, *Legal Opinion Liability*, in DRAFTING LEGAL OPINION LETTERS 419-31 (J. Sterba ed. 1988).

II. THE DEFINITION OF SCIENTER

A. *The Common-Law Standard for Scienter*

1. *Primary Liability*

The seminal common-law case on the mental element of the cause of action for fraud or deceit, usually referred to as scienter,¹³ is the English case of *Derry v. Peek*.¹⁴ In *Derry* a special act of Parliament had authorized the Plymouth, Devonport & District Tramway Company to make certain tramways. The act provided that the tramways could be moved by animal power and, with consent of the Board of Trade, by steam or mechanical power for a fixed period subject to regulation by the Board. In February 1883 the directors of the company issued a prospectus with the following statement:

One great feature of this undertaking, to which considerable importance should be attached, is, that by the special Act of Parliament obtained, the company has the right to use steam or mechanical motive power, instead of horses, and it is fully expected that by means of this a considerable saving will result in the working expenses of the line as compared with other tramways worked by horses.¹⁵

The company proceeded to produce tramways but the Board of Trade refused to consent to the use of steam or mechanical power, except on certain portions of the tramways. As a result, the company went out of business. The plaintiff, a purchaser of the company's stock, sued, alleging that the prospectus had fraudulently induced him to acquire his shares.

The trial court found for the defendants on the ground that they

13. Scienter is only one of the elements of a cause of action for fraud. The elements have been summarized as follows:

1. A false representation made by the defendant. In the ordinary case, this representation must be one of fact.
2. Knowledge or belief on the part of the defendant that the representation is false—or, what is regarded as equivalent, that he has not a sufficient basis of information to make it. This element often is given the technical name of “scienter.”
3. An intention to induce the plaintiff to act or to refrain from action in reliance upon the misrepresentation.
4. Justifiable reliance upon the representation on the part of the plaintiff, in taking action or refraining from it.
5. Damage to the plaintiff, resulting from such reliance.

W. KEETON, D. DOBBS, R. KEETON, & D. OWEN, *PROSSER AND KEETON ON THE LAW OF TORTS* 728 (5th ed. 1984) (footnotes omitted) [hereinafter *Prosser & Keeton*].

14. 14 App. Cas. 337 (H.L. 1889).

15. *Id.* at 338.

had believed honestly that their statements were true. The court of appeals reversed. Justice Cotton had stated the applicable rule in the court below:

"What in my opinion is a correct statement of the law is this, that where a man makes a statement to be acted upon by others which is false, and which is known by him to be false, or is made by him recklessly, or without care whether it is true or false, *that is, without any reasonable ground for believing it to be true*, he is liable in an action of deceit at the suit of anyone to whom it was addressed or anyone of the class to whom it was addressed and who was materially induced by the misstatement to do an act to his prejudice."¹⁶

The House of Lords reversed. Lord Herschell drew a distinction between a statement made honestly but without reasonable belief in its truth, and a statement made recklessly, without caring whether it was true or false.¹⁷ To Lord Herschell the latter was fraudulent, while the former was not.¹⁸ Thus, Lord Herschell summarized the requirements for proof of fraud: "[F]raud is proved when it is shewn that a false representation has been made (1) knowingly, or (2) without belief in its truth, or (3) recklessly, careless whether it be true or false."¹⁹

Lord Herschell differentiated between the legal standard for fraud and evidence of fraud:

I think there is here some confusion between that which is evidence of fraud, and that which constitutes it. A consideration of the grounds of belief is no doubt an important aid in ascertaining whether the belief was really entertained. A man's mere assertion that he believed the statement he made to be true is not accepted as conclusive proof that he did so. There may be such an absence of reasonable ground for his belief as, in spite of his assertion, to carry conviction to the mind that he had not really the belief which he alleges.²⁰

Applying the principles to the facts of the case, Lord Herschell

16. *Id.* at 360-61 (emphasis added) (quoting opinion of Cotton, L.J., in the lower court).

17. *Id.* at 359-80.

18. *See id.* at 361.

19. *Id.* at 374. Earlier in the opinion, Lord Herschell stated that a person could be liable for fraud even though the person did not know that his statement was false:

[A] person making any statement which he intends another to act upon must be taken to warrant his belief in its truth. Any person making such a statement must always be aware that the person to whom it is made will understand, if not that he who makes it *knows*, yet at least that he *believes* it to be true. And if he has no such belief he is as much guilty of fraud as if he had made any other representation which he knew to be false, or did not believe to be true.

Id. at 368 (emphasis in original).

20. *Id.* at 369.

ruled that the court of appeals erred in finding fraud and reinstated the decision of the trial judge dismissing the action. He placed great weight on the trial judge's acceptance of the defendants' testimony, because he had the opportunity to observe the demeanor of the witnesses.²¹ The defendants' testimony showed that they had submitted plans to use mechanical power to the Board of Trade and that they had received no objection to their proposal. The defendants also testified that they believed that Board of Trade approval was a formality and would follow as a matter of course.²²

Derry holds that a person can be liable for fraud when the person makes a statement recklessly. However, the court defined recklessness narrowly. According to the court, if the person made the statement with an honest but unreasonable belief in its truth, no liability for fraud would lie.

American courts often have been willing to go beyond the narrow concept of recklessness employed in *Derry*. An early example is *Chat-ham Furnace Co. v. Moffatt*,²³ an action for fraud brought by the purchaser of a mine claiming that the defendant had misrepresented the quantity of ore in the mine. The court stated that when a person makes an unqualified assertion of a fact that is susceptible to knowledge, rather than being merely a matter of opinion, the person is liable for fraud if the statement is false, even if the person honestly believed his statement was true.²⁴ Similarly, in *Pumphrey v. Quillen*²⁵ the plaintiffs sued for damages for fraud in connection with the sale of a house. The defendant broker had made representations about the construction of the home that he believed to be true but turned out to be false. The Ohio Supreme Court held that when a person expressly or impliedly asserts a fact of his own knowledge, he will be held liable for fraud if the fact is untrue, even if he believed the fact to be true.²⁶ Other cases have adopted a similar view.²⁷

This broad view of recklessness also has been applied to cases involving the liability of professionals, such as accountants or lawyers, for fraud. The well-known case of *Ultramares Corp. v. Touche*²⁸ is il-

21. *Id.* at 377.

22. *Id.* at 378-79.

23. 147 Mass. 403, 18 N.E. 168 (1888).

24. *Id.* at 406, 18 N.E. at 169-70.

25. 165 Ohio St. 343, 135 N.E.2d 328 (1956).

26. *Id.* at 345, 135 N.E.2d at 330-32.

27. *E.g.*, *Becker v. McKinnie*, 106 Kan. 426, 186 P. 496 (1920) (false statements about quantity of water; defendant cannot escape liability for unqualified statements, even if he believed them to be true). *See generally* Keeton, *Fraud: The Necessity for an Intent to Deceive*, 5 UCLA L. REV. 583 (1958).

28. 255 N.Y. 170, 174 N.E. 441 (1931).

illustrative. In *Ultramares* the defendant, a firm of public accountants, was employed by Fred Stern & Co., a rubber importer, to prepare a balance sheet. The certificate of the defendant, which was attached to the balance sheet, stated as follows:

We have examined the accounts of Fred Stern & Co., Inc., for the year ending December 31, 1923, and hereby certify that the annexed balance sheet is in accordance therewith and with the information and explanations given us. We further certify that, subject to provision for federal taxes on income, the said statement, in our opinion, presents a true and correct view of the financial condition of Fred Stern & Co., Inc., as at December 31, 1923.²⁹

The balance sheet showed that the firm had a net worth of over one million dollars when, in fact, the company was insolvent.³⁰ Fred Stern approached the plaintiff to obtain loans to finance the sale of rubber. As a condition for granting the loans, the plaintiff requested a certified balance sheet. In response Fred Stern gave the plaintiff one of the statements certified by the defendant. During the next year, the plaintiff made a series of loans to Fred Stern until the company declared bankruptcy. The plaintiff brought suit against the accounting firm. Count one alleged that the balance sheet had been prepared negligently; count two claimed fraud. The trial judge dismissed the fraud count without submitting it to the jury, but submitted the negligence count to the jury, which returned a verdict for the plaintiff. The trial judge then granted the defendant's motion to dismiss, which had been reserved pending the jury verdict. The appellate division affirmed the dismissal of the fraud count, but reversed the dismissal of the negligence count and reinstated the verdict.³¹

The bulk of the opinion of the court of appeals focused on the negligence count. Judge Cardozo expressed concern about imposing liability on the defendants "in an indeterminate amount for an indeterminate time to an indeterminate class."³² Without clearly defining the scope of liability for negligence, Cardozo ruled on the facts of the case that the defendant's duty to use due care did not extend to the plaintiff. While rejecting liability for negligence, Cardozo recognized that the defendants could be held liable to the plaintiffs for fraud. Cardozo explained that fraud was not limited to cases of statements known to be false, nor would an honest belief in the truth of the statement necessarily exonerate a person from fraud: "The defendants certified as a fact, true to their own knowledge, that the balance sheet was in accor-

29. *Id.* at 174, 174 N.E. at 442.

30. *Id.* at 175, 174 N.E. at 442.

31. *Id.* at 176, 174 N.E. at 443.

32. *Id.* at 179, 174 N.E. at 444.

dance with the books of account. If their statement was false, they are not to be exonerated because they believed it to be true.”³³

The *Restatement (Second) of Torts* adopts the American view of liability for fraud for statements that are made recklessly. Section 526, captioned “Conditions under which Misrepresentation is Fraudulent (Scienter)”³⁴ provides:

- A misrepresentation is fraudulent if the maker
 - (a) knows or believes that the matter is not as he represents it to be,
 - (b) does not have the confidence in the accuracy of his representation that he states or implies, or
 - (c) knows that he does not have the basis for his representation that he states or implies.³⁵

The comments develop the scope of these rules in greater detail. Under comment d, a statement made negligently is not enough to impose liability for fraud. Negligence, however, is evidence that a statement was made without honest belief in its truth.³⁶ Comment e provides that liability for fraud may be found even though the maker of the statement did not know or believe that his statement was false when the statement was made “recklessly”:

It is enough that being conscious that he has neither knowledge nor belief in the existence of the matter he chooses to assert it as a fact. Indeed, since knowledge implies a firm conviction, a misrepresentation of a fact so made as to assert that the maker knows it, is fraudulent if he is conscious that he has merely a belief in its existence and recognizes that there is a chance, more or less great, that the fact may not be as it is represented. This is often expressed by saying that fraud is proved if it is shown that a false representation has been made without belief in its truth or recklessly, careless of whether it is true or false.³⁷

33. *Id.* at 189, 174 N.E. at 448.

34. RESTATEMENT (SECOND) OF TORTS § 526 (1977).

35. *Id.*

36. Comment d provides:

The fact that the misrepresentation is one that a man of ordinary care and intelligence in the maker’s situation would have recognized as false is not enough to impose liability upon the maker for a fraudulent misrepresentation under the rule stated in this Section, but it is evidence from which his lack of honest belief may be inferred. So, too, it is a matter to be taken into account in determining the credibility of the defendant if he testifies that he believed his representation to be true.

Id. comment d.

37. *Id.* comment e. See also *id.* § 527(c), which provides that a maker of an ambiguous statement is liable for fraud if he makes the statement “with reckless indifference as to how it will be understood.”

Comment f states that when a person makes a representation either expressly or impliedly based on his personal knowledge or on his personal investigation, he is liable for fraud if the statement is false even though the maker honestly believes in the truth of his statement.³⁸

2. *Secondary Liability for Intentional Acts at Common Law: Civil Conspiracy and Aider and Abettor Theory*

Since the earliest days of the English common law, courts have recognized a basis for liability based on actions taken in concert with others. The writ of conspiracy, though originally limited to conspiracies to prosecute another, gradually widened to cover other misconduct.³⁹ Writing in 1937, Professor William Prosser attempted to bring some intellectual order to the area of "joint torts" by organizing the case law into nine categories.⁴⁰ For our purposes, two of these are of particular significance: liability for tortious conduct done pursuant to a common design (civil conspiracy liability) and liability for rendering substantial assistance to the tortious conduct of another (aider and abettor liability). Both find expression in section 876 of the *Restatement (Second) of Torts*:

§ 876. Persons Acting in Concert

For harm resulting to a third person from the tortious conduct of another, one is subject to liability if he

(a) does a tortious act in concert with the other or pursuant to a common design with him, or

(b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself, or

(c) gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person.⁴¹

The comments to section 876 clarify the elements and relationship

38. *Id.* § 526(f).

39. 3 W. HOLDSWORTH, A HISTORY OF THE COMMON LAW 401-07 (1973).

40. Prosser, *Joint Torts and Several Liability*, 25 CALIF. L. REV. 413, 429-42 (1937).

41. RESTATEMENT (SECOND) OF TORTS § 876 (1977). RESTATEMENT (SECOND) OF AGENCY § 348 (1957) is similar:

Fraud and Duress

An agent who fraudulently makes representations, uses duress, or knowingly assists in the commission of tortious fraud or duress by his principal or by others is subject to liability in tort to the injured person although the fraud or duress occurs in a transaction on behalf of the principal.

of the civil conspiracy and aider and abettor theories of liability. Civil conspiracy⁴² is composed of two elements. First, "an agreement to co-operate in a particular line of conduct or to accomplish a particular result"⁴³ must exist. However, the agreement need not be express, but may be implied from the actors' conduct.⁴⁴ Second, each of the parties to the conspiracy must engage in tortious conduct.⁴⁵ Under the *Restatement* formulation, the mere existence of a common plan or design is not sufficient to establish liability. As comment c states:

In order for the rules stated in Clause (a) to be applicable, it is essential that the conduct of the actor be in itself tortious. One who innocently, rightfully and carefully does an act that has the effect of furthering the tortious conduct or cooperating in the tortious design of another is not for that reason subject to liability.⁴⁶

The California Supreme Court recently dealt with the scope of professional liability for civil conspiracy under a common-law theory. In *Doctors' Co. v. Superior Court*⁴⁷ the plaintiff brought a medical malpractice action against the doctor's insurer. Count I of the complaint charged the insurer with violating its statutory duty to attempt settlement. Count II alleged that the attorneys retained by the insurer entered into a conspiracy with the insurer to retain a doctor who only partially would review the facts and records surrounding the medical malpractice action and would then give a false medical opinion that the insurer could use as an excuse to deny prompt settlement of the plaintiff's claim. Citing earlier California cases, the court enumerated the elements of a claim for civil conspiracy:

"The elements of an action for civil conspiracy are the formation and operation of the conspiracy and damage resulting to plaintiff from an act or acts done in furtherance of the common design. . . . In such an action the major significance of the conspiracy lies in the fact that it renders each participant in the wrongful act responsible as a joint tortfeasor for all damages ensuing from the wrong, irrespective of whether or not he was a direct actor and regardless of the degree of his activity."⁴⁸

The court then discussed the requirement of acts in furtherance of

42. RESTATEMENT (SECOND) OF TORTS § 876 comment b (1977) refers to "conspiracy."

43. *Id.* comment a.

44. *Id.*

45. *Id.* comment c.

46. *Id.*

47. 49 Cal. 3d 39, 775 P.2d 508, 260 Cal. Rptr. 183 (1989) (en banc).

48. *Id.* at 44, 775 P.2d at 510-11, 260 Cal. Rptr. at 185-86 (quoting *Mox, Inc. v. Woods*, 202 Cal. 675, 262 P. 302 (1927)).

the conspiracy:

A cause of action for civil conspiracy may not arise, however, if the alleged conspirator, though a participant in the agreement underlying the injury, was not personally bound by the duty violated by the wrongdoing and was acting only as the agent or employee of the party who did have that duty.⁴⁹

Finding that the statutory duty involved applied only to the insurers and not to the attorneys, the court entered an order requiring dismissal of the conspiracy claim against the attorneys.

The court was careful, however, to point out the limited nature of its holding and to emphasize that in other situations attorneys could be liable for conspiracy with their clients. The court furnished several examples of situations in which a conspiracy claim could be asserted. First, an attorney may be held liable for a civil conspiracy if the attorney is "acting not only in the performance of a professional duty to serve the client but also in furtherance of the attorney's own financial gain."⁵⁰ The court cited *Black v. Sullivan*,⁵¹ in which attorneys were held liable for aiding and abetting and conspiring with their clients, the trustees of a trust, to fail to provide a statement of balance due as required by statute. The attorneys had a personal financial interest in the matter because they had taken an assignment of an interest in the trust as security for their legal fees. Second, when the attorney's conduct violates the attorney's own duty to the plaintiff, the attorney may be held liable for a civil conspiracy. The court cited *Barney v. Aetna Casualty & Surety Co.*,⁵² in which attorneys retained by the insurer to defend the insured settled the suit without notice to the insured. The insured's conspiracy action against the attorneys and the insurer was upheld since the attorneys had violated an independent fiduciary duty to the insured. Third, when attorneys or other agents engage in actual fraud, they can be held liable for conspiracy because they possess an independent duty not to engage in actionable misrepresentation.⁵³ The court also averred that its holding did not apply to corporate officers and directors "who directly order, authorize, or participate in the corporation's tortious conduct. Such persons may be held liable, as conspirators or otherwise, for violation of their own duties towards persons injured by the corporate tort."⁵⁴

Doctors' Co. creates an undeserved and illogical loophole for law-

49. *Id.*, 775 P.2d at 511, 260 Cal. Rptr. at 186.

50. *Id.* at 46, 775 P.2d at 512, 260 Cal. Rptr. at 187 (emphasis added).

51. 48 Cal. App. 3d 557, 122 Cal. Rptr. 119 (1975).

52. 185 Cal. App. 3d 966, 230 Cal. Rptr. 215 (1986).

53. *Doctors' Co.*, 49 Cal. 3d at 48, 775 P.2d at 513, 260 Cal. Rptr. at 188.

54. *Id.*

yers who knowingly participate in their clients' wrongs as conspirators. First, the opinion lacks symmetry. Breach of a direct duty flowing from the conspirator-lawyer to the victim was demanded, and three situations were posited in which a lawyer can be liable as a co-conspirator: (1) through participation in actual fraud, (2) through breach of a direct duty owed to the victim, and (3) when the lawyer acts in furtherance of his own financial gain. If civil conspiracy liability requires breach of a separate duty, the first two situations qualify, but not the third. The third factor goes to scienter and motive, not to duty.

Also suspect is the logic underlying the court's willingness to impose conspirator liability on the insurer's directors or officers who authorize or participate in the corporation's tortious conduct, but not to "subordinate employees and . . . agents retained . . . as independent contractors" ⁵⁵ If, as the court suggested, conspiratorial acts by agents with their principals are not reached by a civil conspiracy theory, then it is hard to understand why the court envisioned insider agents as appropriate targets of a civil conspiracy claim. As between the two types of conspirators, the outsiders' lack of close connection to their principals suggests they could more easily fill the co-conspirator bill. Contrary to the *Doctors' Co.* court's suggestion, a civil conspiracy between a company and outside counsel arguably is easier to establish than one with inside counsel. ⁵⁶

There is also a logical problem with discriminating between corporate insiders and outsiders. If exactly the same injuries are caused by Insurer A's in-house Senior Vice-President/General Counsel, and, in a second case, by the senior partner of Insurer B's agent-independent contractor outside counsel, *Doctors' Co.* holds that the in-house general counsel may face conspiracy liability, but the outside lawyer will not. This is arbitrary. Disparate treatment cannot be justified based on the overt acts performed, since they are the same. Nor is there any differ-

55. *Id.*, 260 Cal. Rptr. at 189.

56. One court has asserted:

A corporate conspiracy requires more than the collective judgment of two individuals within the same entity, for their conduct, if challenged, becomes that of the single, corporate entity. *Jagielski v. Package Mach. Co.*, 489 F. Supp. 232 (E.D. Pa. 1980); see, e.g., *Thompson*, 412 A.2d at 473; *Chambers Development Co., Inc. v. Browning-Ferris Industries*, 590 F. Supp. 1528, 1541-42 (W.D. Pa. 1984). Pursuant to this precedent, defendants argue that the conspiracy alleged in the Complaint describes defendants acting in their corporate capacities. As such, they acted as part of the corporate singularity and, thus, cannot conspire with that singularity. If such was the only credible reading of Mr. Sanzone's Complaint, this court would be compelled to dismiss the civil conspiracy count.

Hudick v. Phoenix Technologies, Inc., 1990 WL 51053 (E.D. Pa. Apr. 19, 1990) (WESTLAW).

ence from the victim's standpoint, since the injury in either case is identical. Nor can exempting the independent contractor-lawyer from liability be justified based on the coincidence of full-time employment, since the professional obligation of either lawyer in handling the matter is the same. Both hypothetical lawyers have a general professional obligation not to counsel or knowingly assist their clients' fraudulent or criminal acts.⁵⁷ Indeed, it is questionable why this global, independent professional obligation not to further impropriety would not itself suffice to supply any necessary "breach of duty" element.

Doctors' Co. illustrates the tendency of courts to engineer results to protect lawyers (at least outside counsel) as a class. It also shows the irrationality that arbitrary classifications foster. A more direct and principled approach to professional conspiracy liability at common law recognizes that the confluence of an agreement, plus a wrongful act by "one of the parties in pursuance of the agreement,"⁵⁸ plus damage to the victim proximately caused, may yield the tort of civil conspiracy.⁵⁹ This latter approach was taken by the California federal district court in *Koehler v. Pulvers*.⁶⁰ The *Koehler* court upheld a civil conspiracy claim in a limited partnership case against a lawyer alleged to have conspired in the developers' breach of their fiduciary duty owed to the limited partner investors.⁶¹ Implicitly recognized in *Koehler*, but never

57. See MODEL RULES OF PROFESSIONAL CONDUCT Rules 1.2(d), 1.13, 1.16(a)(1) (1983); MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 1-102(4), 7-102(A)(1), (7), (8) (1980); RULES OF PROFESSIONAL CONDUCT OF THE STATE BAR OF CAL. Rule 3-210. See also RESTATEMENT (SECOND) OF AGENCY § 348 (1957) (agent liable for knowingly assisting fraud or duress).

58. Prosser & Keeton, *supra* note 13, § 46, at 324.

59. Of course, this depends on which state is involved. For example, New York does not recognize an independent tort of civil conspiracy. See *Legion Lighting v. Switzer Group, Inc.*, — A.2d —, 567 N.Y.S.2d 52 (1991). Other states do, including Maryland, Michigan, Pennsylvania, Texas, and South Carolina. See *Green v. Washington Suburban Sanitary Comm'n*, 259 Md. 206, 269 A.2d 815 (1970); *Fenestra Inc. v. Gulf Am. Land Corp.*, 377 Mich. 565, 141 N.W.2d 36 (1966); *Thompson Coal Co. v. Pike Coal Co.*, 488 Pa. 198, 412 A.2d 466 (1979); *Schlumberger Well Surveying Corp. v. Nortex Oil & Gas Corp.*, 435 S.W.2d 854 (Tex. 1968). In South Carolina, "[a] civil conspiracy . . . consists of three elements: (1) a combination of two or more persons, (2) for the purpose of injuring the plaintiff, (3) which causes him special damage." *Lee v. Chesterfield Gen. Hosp., Inc.*, 289 S.C. 6, 10, 344 S.E.2d 379, 382 (Ct. App. 1986). See also *Yaeger v. Murphy*, 291 S.C. 485, 354 S.E.2d 393 (Ct. App. 1987). Other states have other formulations. For example, Texas recognizes that civil conspiracy consists of "'a combination by two or more persons to accomplish an unlawful purpose or to accomplish a lawful purpose by unlawful means.'" *Fenslage v. Dawkins*, 629 F.2d 1107, 1110 (5th Cir. 1980) (quoting *Schlumberger Well Surveying v. Nortex Oil & Gas*, 435 S.W.2d 854, 856 (Tex. 1968)).

60. 606 F. Supp. 164 (S.D. Cal. 1985).

61. The court in *Koehler* cited with approval the leading California case of *Roberts v. Ball, Hunt, Hart, Brown & Baerwitz*, 57 Cal. App. 3d 104, 109, 128 Cal. Rptr. 901, 905 (1976), for the proposition that "'California has long adopted the view that an attorney

considered in *Doctors' Co.*, is the well-established tenet that "unless there is a privilege to do so, a person is under a duty to refrain from intentionally causing another to violate a duty to a third."⁶²

In retrospect, perhaps the plaintiff in *Doctors' Co.* would have fared better by including an aider and abettor claim against the lawyer attacked as a co-conspirator. A plaintiff must prove two elements to establish aider and abettor liability tied to another's wrong. First, the alleged aider and abettor must know that the primary actor's conduct constitutes a breach of some duty. Second, the defendant must knowingly give "substantial assistance or encouragement" to the other.⁶³ The scope of common-law aider and abettor liability is illustrated by the recent case of *Blow v. Shaughnessy*.⁶⁴ *Blow* involved an action against an investment advisor for fraud in connection with the handling of investment accounts. Several brokers were accused of aiding and abetting the fraud by executing trades for the advisor when they had knowledge of the fraud.

Relying on subsection 876(b) and federal court decisions in securities litigation, the court in *Blow* recognized a common-law action for aiding and abetting a tort. The court defined the action as having three elements: (1) the existence of a securities law violation by the primary party; (2) knowledge of the violation on the part of the aider and abettor; and (3) substantial assistance by the aider and abettor in the achievement of the primary violation.⁶⁵

Focusing on the requirement of "substantial assistance," the court approved the following instruction given by the trial court: "Substantial assistance is defined as a large amount or quantity of assistance as distinguished from nominal or routine assistance. Assistance may be said to be substantial when it was a significant factor in bringing about the violation complained of, that is, the false reporting of unit values."⁶⁶ The court also ruled that inaction could be a basis of liability when the person either owed the victim an independent duty or consciously intended to assist in the perpetration of the wrong.⁶⁷ With its

may not with impunity, either conspire with a client to defraud or injure a third person or engage in intentional tortious conduct toward a third person.'" *Koehler*, 606 F. Supp. at 173.

62. RESTATEMENT (SECOND) OF AGENCY § 312 comment a (1957).

63. RESTATEMENT (SECOND) OF TORTS § 876(b) (1977). Subsection 876(c) discusses another form of aider and abettor liability. This subsection dispenses with the requirement of knowledge of the other party's tortious conduct, but adds the requirement that the aider and abettor's conduct be a breach of duty to the third person.

64. 88 N.C. App. 484, 364 S.E.2d 444 (1988).

65. *Id.* at 490, 364 S.E.2d at 447.

66. *Id.* at 488, 364 S.E.2d at 447.

67. *Id.* at 490-91, 364 S.E.2d at 447-48. The court affirmed a jury verdict for the securities brokers. The jury's verdict can be justified either on the ground that the de-

common sense, *Restatement*-grounded logic that knowing complicity is as wrongful as the independent wrong itself, *Blow* and its progeny⁶⁸ promise to create scienter-related problems in common-law cases for generations of professionals to come.

B. Defining Scienter in Securities and Civil RICO Suits Against Professionals

1. Introduction

In addition to common-law theories, civil cases against professionals tend to be built around claims of securities fraud or RICO allegations premised on mail fraud, wire fraud, and conspiracy, fields in which there is already a fair amount of criminal precedent.⁶⁹ Criminal law precedent must logically furnish the scienter standard for civil RICO cases, since the statute merely allows civil recovery for what are criminal acts.⁷⁰ This is not the same thing as saying that the scienter requirement in civil RICO cases automatically ratchets upward to cold-blooded, deliberate intent, however. As will be discussed, "knowledge" is easier to establish in criminal cases than civil litigators may imagine, and, for many purposes, recklessness can suffice to provide an inference of guilty knowledge and criminal culpability. Criminal cases dealing with the intent issue are considered in a subsequent section.⁷¹

fendant brokers did not know of the fraud (they denied being informed) or that the execution of trades alone was not sufficient assistance for aider and abettor liability.

68. The concept that one may wrongfully aid and abet another's breach of duty, and thus become liable for it, is not well developed at common law. Recently, in the investment fraud case of *In re Rospatch Sec. Litig.*, 760 F. Supp. 1239 (W.D. Mich. 1991), the district court professed not to find "any law recognizing this cause of action." *Id.* at 1265. The law firm in the *Rospatch* case was charged with having aided and abetted a breach of trust. Notwithstanding the district court's comment about a lack of authority, *Blow* is on the books, and it is clear that complicity in another's misconduct may be actionable at common law. See, e.g., *supra* note 63 and accompanying text.

69. See, e.g., *United States v. Nicholson*, 677 F.2d 706, 710-11 (9th Cir. 1982) (drug conspiracy); *United States v. Brien*, 617 F.2d 299, 312 (1st Cir.) (mail fraud), *cert. denied*, 446 U.S. 919 (1980); *United States v. Joyce*, 499 F.2d 9, 23 (7th Cir.) (mail fraud), *cert. denied*, 419 U.S. 1031 (1974); *United States v. Sarantos*, 455 F.2d 877, 880, 882 (2d Cir. 1972) (conspiracy); *United States v. Sheiner*, 410 F.2d 337, 340-41 (2d Cir.) (mail and wire fraud), *cert. denied*, 396 U.S. 825 (1969); *United States v. Benjamin*, 328 F.2d 854 (2d Cir.) (securities fraud), *cert. denied*, 377 U.S. 953 (1964).

70. See Mathews, *Shifting the Burden of Losses in the Securities Markets: The Role of Civil RICO in Securities Litigation*, 65 NOTRE DAME L. REV. 896, 949-53 (1990).

71. See *infra* notes 199-294 and accompanying text.

2. The Recklessness Standard

In civil suits brought under rule 10b-5, reckless misconduct supports a finding of scienter,⁷² with recklessness defined as “highly unreasonable” conduct involving “not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.”⁷³ This basic recklessness/scienter articulation has been approved by a majority of the circuits.⁷⁴ In the Fifth and Eleventh Circuits the definition travels under the name “severe recklessness.”⁷⁵

Despite courts having had decades to refine the culpability element in 10b-5 cases, the federal precedent has been criticized for lacking consistency:

Most federal circuits have approved some use of recklessness to satisfy the scienter requirement in 10b-5 actions. There is little uniformity, however, among the circuits or even among different panels of the same circuit, on how proof of recklessness should be used to satisfy scienter. As one district court judge noted, the recklessness footnote in *Hochfelder* “has served as a veritable quagmire for the courts.”⁷⁶

72. *E.g.*, T. HAZEN, *THE LAW OF SECURITIES REGULATION*, § 13.4, at 685-87 (2d ed. 1990).

73. *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569 (9th Cir. 1990), *cert. denied*, 111 S. Ct. 1621 (1991) (quoting *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977)). The *Hollinger* court quoted the *Sundstrand* court’s amplification of the standard: “[T]he danger of misleading buyers must be actually known or so obvious that any reasonable man would be legally bound as knowing, and the omission must derive from something more egregious than even ‘white heart/empty head’ good faith.” *Id.* at 1569-70 (footnotes omitted).

74. *See, e.g.*, *Hollinger*, 914 F.2d at 1569 (9th Cir. 1990); *Hackbart v. Holmes*, 675 F.2d 1114, 1118 (10th Cir. 1982); *SEC v. Carriba Air, Inc.*, 681 F.2d 1318, 1324 (11th Cir. 1982); *Broad v. Rockwell Int’l Corp.*, 642 F.2d 929, 961-62 (5th Cir. Apr.), *cert. denied*, 454 U.S. 965 (1981); *McLean v. Alexander*, 599 F.2d 1190, 1197-98 (3d Cir. 1979); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1025 (6th Cir. 1979); *Cook v. Avien, Inc.*, 573 F.2d 685, 692 (1st Cir. 1978); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 46-47 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977).

75. *Shivangi v. Dean Witter Reynolds, Inc.*, 825 F.2d 885, 889 (5th Cir. 1987); *Woods v. Barnett Bank*, 765 F.2d 1004, 1010 (11th Cir. 1985). Another name advocated (without success) is “egregious recklessness.” *See In re Network Equip. Technologies, Inc. Litig.*, 762 F. Supp. 1359, 1363 (N.D. Cal. 1991).

76. *Milich, Securities Fraud Under Section 10(b) and Rule 10b-5: Scienter, Recklessness, and the Good Faith Defense*, 11 J. CORP. L. 179, 180 (1986) (quoting *SEC v. Pavo*, 468 F. Supp. 635, 647 (N.D.N.Y. 1979)). The “recklessness footnote” in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976), reads in relevant part as follows:

On the one hand, those forced to cope with uncertainty over 10b-5's scienter element should not be disheartened. As noted below, criminal law has been around for centuries, and there is still confusion over where the boundary line for intent or knowledge should be fixed.⁷⁷ On the other hand, some discrepancies are developing about how courts decide 10b-5 recklessness cases.

3. *Altering the Culpability Standard Based on the Defendant's Status*

a. *The Duty-to-Disclose Requirement in the Second and Seventh Circuits*

A growing number of courts have created a culpability formulation in securities fraud aider and abettor cases,⁷⁸ requiring victims of securities fraud to establish a fiduciary relationship or similar relationship of trust and confidence in order to hold the professional liable based on reckless misconduct. Thus, in *Ross v. Bolton*⁷⁹ the Second Circuit held that reckless misconduct would not suffice to establish scienter in a 10b-5 aider and abettor case absent a fiduciary relationship between the plaintiff and the alleged aider and abettor.

In this opinion the term "scienter" refers to a mental state embracing intent to deceive, manipulate, or defraud. In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5.

77. See *infra* notes 199-258 and accompanying text.

78. According to the SEC:

In the context of the federal securities laws . . . one may be found to have aided and abetted a violation when the following three elements are present:

1. there exists an independent securities law violation committed by some other party;
2. the aider and abettor knowingly and substantially assisted the conduct that constitutes the violation; and
3. the aider and abettor was aware or knew that his role was part of an activity that was improper or illegal.

In re Carter & Johnson, SEC Act Release No. 17,597 [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,847, at 84,166 (Feb. 28, 1981).

79. 904 F.2d 819, 824 (2d Cir. 1990). See also *Schatz v. Rosenberg*, 943 F.2d 485 (4th Cir. 1991) (appearing to require a "duty running from the alleged aider and abettor to the plaintiff" in order to find a recklessness scienter standard); *Edwards & Hanly v. Wells Fargo Sec. Clearance Corp.*, 602 F.2d 478, 484 (2d Cir. 1979) ("The scienter requirement scales upward when activity is more remote . . ."), *cert. denied*, 444 U.S. 1045 (1980); L. LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 1185 (1983) (suggesting that actual knowledge is required for secondary liability under Rule 10b-5).

Showing that the alleged aider and abettor owed a duty to disclose, though not necessarily premised on a trust and confidence relationship, is now a featured requirement in 10b-5 aider and abettor cases arising in the Seventh Circuit. In *DiLeo v. Ernst & Young*,⁸⁰ the circuit court explained: “[T]here can be no liability on an aiding-and-abetting theory unless (1) someone committed a primary violation, (2) positive law obliges the abettor to disclose the truth, and (3) the abettor fails to do this, with the same degree of scienter necessary for the primary violation.”⁸¹ Of course, if “positive law requires the abettor to disclose the truth,” then, if this is not done, the abettor is a “principal,” or a primary wrongdoer. Exactly why it should be necessary to establish that an aider and abettor is a primary wrongdoer, in order to establish secondary liability, is something the Seventh Circuit has failed to explain. Likewise, the Second Circuit has yet to explain why a fraud victim should need to prove a breach of fiduciary duty case to assert aider and abettor liability.⁸²

80. 901 F.2d 624 (7th Cir.), *cert. denied*, 111 S. Ct. 347 (1990).

81. *Id.* at 628.

82. The Seventh Circuit now has extended the requirement of a special showing for secondary liability of professionals to conspiracy cases as well as aider and abettor cases. In *First Interstate Bank v. Chapman & Cutler*, 837 F.2d 775 (7th Cir. 1988), the defendant law firm gave an opinion to a county board, thereby satisfying a condition precedent to the issuance of municipal bonds. The opinion, though important in facilitating the transaction, was never seen or directly relied upon by public investors. The firm's opinion was based on certain assumed facts “not consistent with the actual facts Chapman and Cutler had learned earlier,” *id.* at 777, with the result that the firm supposedly gave an opinion resting on an assumption it knew to be false. The appellate court ruled for the law firm on three grounds: (1) the proceeds of the offering were misapplied and this constituted a superseding event, *id.* at 779-80; (2) no duty to disclose was breached, *id.* at 780 n.4; and (3) no allegation was made that the law firm agreed to a scheme to defraud the bondholders. *Id.* at 780. If the firm had been communicating directly with the public, the court would have had an easier time finding the breach of a duty to disclose. In any event, the appellate court plainly was not sympathetic to the plaintiffs' conspiracy claim against a large, distinguished local law firm:

The complaint is barren of any allegations that Chapman and Cutler actually agreed to a scheme to defraud bond investors or facts from which such agreement could be reasonably inferred. Conclusory assertions that Chapman and Cutler was “engaged in a fraudulent common plan” are simply not enough. Dismissal of a complaint containing only conclusory, vague, and general allegations of conspiracy is proper.

Id. (footnote omitted) (emphasis in original).

The law firm gave a “necessary” professional opinion, *id.* at 777, which included assumptions it knew to be false. If this does not raise an inference of knowing participation in fraud, then what would? If a lawyer “cannot counsel others to make statements in the face of obvious indications of which he is aware that those assertions are not true,” *United States v. Sarantos*, 455 F.2d 877, 881 (2d Cir. 1972), then why may a lawyer make statements like those made in *Chapman & Cutler* with impunity?

b. *The Fifth Circuit's Sliding Scale Approach*

The Second and the Seventh Circuits are not alone in striving to protect wayward professionals. A Fifth Circuit case exemplifying the same sort of pro-defense leaning found in the Second and Seventh Circuits is *Abell v. Potomac Insurance Co.*⁸³ In *Abell*, the court reversed a jury verdict returned against the underwriter's counsel based on Section 12, Rule 10b-5, the Louisiana Blue Sky Law, negligent misrepresentation, common-law fraud, legal malpractice, breach of fiduciary duty, and statutory aider and abettor liability under state law. In so holding, the appeals court manifested extreme protectiveness toward lawyers caught up in a financial debacle.

The plaintiffs in *Abell* were victims of a municipal bond swindle. The defendant lawyers had served as counsel to the underwriter. The jury verdict against the law firm was supported by expert testimony, apparently credited on appeal, that the firm "failed seriously in its due diligence duties to investigate the bond transaction,"⁸⁴ and the court conceded that the firm "recklessly disregarded its duties to its clients."⁸⁵ The court rejected plaintiffs' contention that aider and abettor liability applied, finding that although the firm's services had assisted the fraud, and although the firm had "ignored several warning signs that the jury could have found aroused the law firm to suspect the propriety of the offering,"⁸⁶ it still was not generally aware of its role in furthering a fraudulent scheme, and had not given knowing assistance.⁸⁷ In holding that scienter had not been shown, the Fifth Circuit embraced a chameleon-like scienter element that changes color depending on where in the scheme the alleged wrongdoer is situated. The *Abell* court embraced "a single test for scienter that varies as the level of assistance decreases on a sliding scale from recklessness to 'conscious intent.'"⁸⁸

Significantly, the court in *Abell* differentiated the exposure faced by the defendant law firm, which had functioned as underwriters' counsel in the bond offering, from the exposure of lawyers who render opinions to third parties, including bond counsel.⁸⁹ The court clearly considered that bond counsel run a greater risk of liability to investors than do underwriters' counsel.⁹⁰ Here, as in the Second Circuit's fiduci-

83. 858 F.2d 1104 (5th Cir. 1988), cert. denied, 492 U.S. 918 (1989).

84. *Id.* at 1111.

85. *Id.* at 1128.

86. *Id.*

87. *Id.* at 1126-27.

88. *Id.* at 1127.

89. *Id.* at 1125-26.

90. In noting that the firm had "failed to investigate properly the truth of the of-

any duty line of cases, the standard for mental state was adjusted based on the defendant's physical nexus to the injured party.

All other things being equal, it is hard to fathom why underwriters' counsel deserve a more forgiving scienter standard than bond counsel. The reason either group of lawyers is hired is to produce an honest offering document that protects the interests of all concerned. Underwriters' counsel cannot protect their clients and, at the same time, disregard the interests of investors. Underwriters' counsel provide protection for the underwriters through the exercise of due diligence in favor of investors. After all, the most worrisome legal risk facing the underwriters in an offering is that the investors will be misled and sue.

Far less generous to underwriters' counsel than *Abell* was the district court in *In re Flight Transportation Corp. Securities Litigation*.⁹¹ The court upheld 10b-5 claims against lawyers for the underwriter who participated in preparing the offering document, as did the lawyers in *Abell*.⁹² The lawyers were charged with, among other things, having acted in reckless disregard of the facts,⁹³ (precisely what was proved, to no avail, in *Abell*). Likewise, in 1989, a Second Circuit panel affirmed per curiam in *SEC v. Calvo*⁹⁴ the "comprehensive, well reasoned, reported opinion"⁹⁵ of the district court in *SEC v. Electronics Warehouse, Inc.*⁹⁶ The lower court expressly had found that an underwriter's counsel who drafted documents that foreseeably would be relied on by the investing public owed a duty to the investing public, and that, in this context, recklessness equalled scienter for aider and abettor liability. *Calvo* thus clashes with *Abell*'s holdings on the duty-owed and scienter issues. It clashes as well with the current vogue in the Second Circuit to elevate the scienter standard when the alleged aider and abettor lacks a fiduciary tie to the victim.

c. *The Fourth Circuit's Position in Schatz v. Rosenberg*

Though *Abell* is a startling decision, it pales in comparison to the Fourth Circuit's August 1991 opinion announcing its entry into the ranks of circuit courts sympathetic to professional defendants. The

fering statement," *id.* at 1127, the court took pains to "re-emphasize that [the law firm's] duty ran to its clients, not to the bondholders." *Id.* n.24.

91. 593 F. Supp. 612 (D. Minn. 1984).

92. *Abell*, 858 F.2d at 1127.

93. *Flight Trans.*, 593 F. Supp. at 617.

94. 891 F.2d 457 (2d Cir. 1989), *cert. denied*, 110 S. Ct. 3228 (1990).

95. *Id.* at 458.

96. 689 F. Supp. 53 (D. Conn. 1988), *aff'd sub nom. SEC v. Calvo*, 891 F.2d 457 (1989), *cert. denied*, 110 S. Ct. 3228 (1990).

case is *Schatz v. Rosenberg*,⁹⁷ a fraud suit based on a close corporation buyout. The defendant law firm of Weinberg & Green represented the buyer who agreed to pay \$1.5 million for eighty percent of the stock in two companies held by Mr. and Mrs. Schatz, the plaintiffs. The sale was to MER Enterprises, a shell company controlled by Rosenberg. In return for their control stock, plaintiffs received a note for the \$1.5 million guaranteed by Rosenberg. The complaint alleged that the Schatzes relied on Rosenberg's financial statement dated March 31, 1986, and an update letter dated December 31, 1986, showing that Rosenberg had a net worth of \$7 million. In fact, the documents contained material misrepresentations "obscuring the fact that Rosenberg's financial empire had crumbled between April and December of 1986."⁹⁸ Weinberg & Green represented Rosenberg and his entities throughout this period.

Weinberg & Green had received a copy of Rosenberg's financial statement, and the firm allegedly knew of its falsity as a result of legal services provided to Rosenberg in the past. Despite this alleged knowledge, the firm prepared documents for the closing, including a clause in the purchase agreement "stating that Rosenberg had delivered his 1986 financial statement and an update letter to the plaintiffs, and that the letters were accurate in all material respects."⁹⁹ At closing the firm delivered the fraudulent update letter and participated in the closing of the transaction. Subsequently, Rosenberg looted the assets of the acquired companies to prop up his failing businesses. Weinberg & Green was paid for its help in making the deal possible out of the cash reserves of the acquired companies. Roughly ten months later, Rosenberg and his operation were in bankruptcy and the companies that plaintiffs sold had been rendered worthless. Unlike Weinberg & Green, Mr. and Mrs. Schatz were never paid. In fact, they lost an additional \$150,000 for a bridge loan they had made to one of Rosenberg's companies. They sued the lawyers, asserting theories under basic agency law concepts, Maryland common law, as well under Rule 10b-5.¹⁰⁰ In affirming a motion to dismiss, the Fourth Circuit held that under no set of facts could plaintiffs possibly recover under any asserted state or federal theory.

The court's treatment of aider and abettor liability is indicative of the opinion's harsh anti-investor, pro-professional tone. Relying on cases from the Second and Fifth Circuits, the court adopted a heightened scienter standard for aider and abettor liability:

97. 943 F.2d 485 (4th Cir. 1991).

98. *Id.* at 488.

99. *Id.* at 489.

100. *Id.* at 488.

[A]n evaluation of the “knowledge” requirement of the aiding and abetting liability test turns upon whether the aider and abettor defendant owed a duty to the plaintiff. When there is no duty running from the alleged aider and abettor to the plaintiff, the defendant must possess a “high conscious intent” and a “conscious and specific motivation” to aid the fraud.¹⁰¹

The Fourth Circuit further tightened the requirements for aider and abettor liability by strictly limiting the definition of “substantial assistance.” According to the court, “the lawyer must actively participate in soliciting sales or negotiating terms of the deal on behalf of a client to have ‘substantially assisted’ a securities violation.”¹⁰² Preparation, dissemination, and presiding over the use of documents containing fraudulent misstatements was not enough assistance.

The court’s treatment of aider and abettor liability under agency law shows a similar, extreme, pro-professional attitude. Plaintiffs had contended that under *Restatement (Second) of Agency* section 348, “an agent who . . . knowingly assists in the commission of a tortious fraud . . . by his principal . . . is subject to liability in tort to the injured person although the fraud . . . occurs in a transaction on behalf of the principal.”¹⁰³ This agency principle clearly is on point. Weinberg & Green served Rosenberg as his agent. If, as alleged, the law firm, through its lawyers, “knowingly assisted” the fraud perpetrated by its principal, then, under section 348, the law firm was culpable.

The Fourth Circuit panel dealt with plaintiffs’ section 348 argument the only way it could and still find for Weinberg & Green as a matter of law: evasion. The court first explained that “the fact that an attorney is an agent . . . does not automatically make the attorney liable under agency law for misrepresentations his client makes.”¹⁰⁴ This is true enough. However, it does not address section 348. The section does not impose strict liability or vicarious liability on the agent. The section attacks agents who “knowingly assist” their principal’s frauds, which is what Weinberg & Green allegedly did.

The court then explained that “lawyers do not vouch for the probity of their clients when they draft documents reflecting their clients’ promises, statements, or warranties.”¹⁰⁵ This also is true. But it does not follow that lawyers are privileged knowingly to further their clients’ frauds in drafting, transmitting, and presiding over the use of those documents. In any event, “vouching” is not essential to liability

101. *Id.* at 496.

102. *Id.* at 497.

103. *Id.* at 494 (quoting RESTATEMENT (SECOND) OF AGENCY § 348 (1957)).

104. *Id.* at 495.

105. *Id.*

under section 348. Liability attaches based on knowing assistance, whether or not any communication is made.

Next, the court explained that "Weinberg & Green's alleged transmission of Rosenberg's misrepresentations does not transform those misrepresentations into the representations of Weinberg & Green."¹⁰⁶ This is also true. But, again, it evades the point of section 348, which is that connivance in the principal's fraud by an agent is actionable. In answer to plaintiff's very solid (if not unanswerable) agency law argument, the court basically filibustered, holding

that a lawyer or law firm cannot be liable for the representations of a client, even if the lawyer incorporates the client's misrepresentations into legal documents or agreements necessary for closing the transactions. In this case, Weinberg & Green merely "papered the deal," that is, put into writing the terms on which the Schatzes and Rosenberg agreed and prepared the documents necessary for closing the transactions. Thus, Weinberg & Green performed the role of a scrivener. Under these circumstances, a law firm cannot be held liable for misrepresentations made by a client in a financial disclosure document.¹⁰⁷

Unquestionably *Schatz* is an extreme case. The Fourth Circuit, already known for its aversion to 10b-5 civil suits,¹⁰⁸ quite simply has created virtual immunity under common law and the federal securities laws for lawyers who knowingly further their clients' investment frauds, so long as counsel have the good sense not to personally sign a fraudulent opinion letter addressed to the victim. Moreover, the Fourth Circuit's safe harbor for the reckless may even be capacious enough to shelter wayward accountants who sign opinion letters in conjunction with their audits. As an example of *Schatz's* zealous pro-defense orientation, consider that the Fourth Circuit took time to imply that a company's auditors might well likewise have immunity if they discovered and failed to do anything about client fraud.¹⁰⁹

106. *Id.*

107. *Id.* The Fourth Circuit brushed aside plaintiffs' citation of agency cases involving fraudulent assistance by a banker and a realtor on the ground that they were "inapposite" because they did not involve lawyers. *Id.* n.4. Clearly, the Fourth Circuit viewed lawyer-agents as privileged to assist frauds knowingly while others in the economy do not enjoy this privilege. The equal protection aspects of this discrimination were not discussed.

108. *E.g.*, *Hunt v. Robinson*, 852 F.2d 786, 787-88 (4th Cir. 1988) (opinion by Judge Wilkinson, joined in by Judge Chapman, both panel members in *Schatz*, announcing "the goal [of § 10(b)] is not furthered by bringing within the ambit of § 10(b) claims amounting to . . . common law fraud which have long been the staples of state law."). *But see* *Chiarella v. United States*, 445 U.S. 222, 234-35 (1980) ("Section 10(b) is aptly described as a catchall provision but what it catches *must be fraud*." (emphasis added)).

109. *Schatz*, 943 F.2d at 493-94. The Fourth Circuit did this by quoting with evident approval the language from *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir.),

4. *Difficulties Raised by Emerging Scienter Approaches*

Schatz and the other pro-professional cases discussed in this subsection raise serious problems. One set of problems pertains to conceptual difficulties caused by the irrationality of conflicting standards. The root of this category of problems is judicial inconsistency. A second set of problems is of a practical nature. Courts will not find it easy to apply the sliding scale or multitier scienter standards engrafted onto the federal common law of 10b-5. Finally, there is the inevitable problem of justifying protecting reckless professionals as sound public policy. These three problem areas are discussed below.

a. *Irrationality and Inconsistency*

Historically, the common law took a dim view of those who knowingly assisted frauds, as illustrated by section 876 of the *Restatement (Second) of Torts* and section 348 of the *Restatement (Second) of Agency*. Section 312 of the *Restatement (Second) of Agency* likewise condemns to joint and several liability those who would intentionally cause or assist an agent to breach a duty to his or her principal. Even the prolawyer holding by California's Supreme Court in *Doctors' Co.* is more balanced than *Schatz* and *Abell*. The California court, after all, was willing to presume that lawyers who knowingly participate in actual fraud would have coequal responsibility with their coparticipants.¹¹⁰

One way to justify departure from basic, well-established norms is to take the view that lawyers (and, perhaps accountants) deserve better treatment than run-of-the-mill agents. Thus, in *Schatz*, we find the court distinguishing cases in which bankers and realtors had been held liable for conduct as agents.¹¹¹ In the eyes of the *Schatz* court, it seems that lawyers deserve greater leeway in furthering frauds than lesser breeds of agents. But this sort of line-drawing is arbitrary. Where in the common law do we find the notion that lawyer-agents are privileged to assist frauds knowingly above other agents? From what accepted source do we draw authorization for this preferential treatment lawyers receive?

The criminal law does not protect from culpability lawyers who knowingly further frauds. The notion that connivers enjoy a heightened intent standard compared to primary wrongdoers was rejected by

cert. denied, 111 S. Ct. 347 (1990). See *infra* note 129 and accompanying text.

110. See *Doctors' Co.*, 49 Cal. 3d 39, 48, 775 P.2d 508, 513, 260 Cal. Rptr. 183, 188.

111. *Schatz*, 943 F.2d at 495 n.4.

the Supreme Court in *United States v. Feola*.¹¹² The Model Penal Code is in accord:

When causing a particular result is an element of an offense, an accomplice in the conduct causing such result is an accomplice in the commission of that offense if he acts with the kind of culpability, if any, with respect to the result that is sufficient for the commission of the offense.¹¹³

In fact, the Fourth Circuit in *Schatz* and other activist courts appear to be establishing a higher scienter level in civil damage suits than applies in criminal cases. Both lawyers¹¹⁴ and accountants¹¹⁵ have been found guilty of criminal violations under a recklessness culpability standard, without a requirement that the prosecution make a special showing of "severe recklessness" or "high conscious intent."¹¹⁶

112. 420 U.S. 684, 686-88 (1975).

113. MODEL PENAL CODE § 2.06(4) (1985). Accomplices generally must act with "the purpose of promoting or facilitating the commission of the offense," *id.* § 2.06(3)(a), but "often, if not usually, aid rendered with guilty knowledge implies purpose since it has no other motivation." MODEL PENAL CODE & COMMENTARIES § 2.06 comment c, at 316 (1985). "Guilty knowledge" under criminal law principles, including those propounded in the Model Penal Code, is a fairly elastic concept, with both the "common law position" and the Model Penal Code's being that reckless misconduct generally suffices to establish criminal culpability. See MODEL PENAL CODE § 2.02(3) (1985); MODEL PENAL CODE & COMMENTARIES § 2.02(3), comment 5, at 244 (1985).

114. *E.g.*, *United States v. Frank*, 520 F.2d 1287 (2d Cir. 1975) (conviction of securities lawyer for conspiracy to violate the securities laws in connection with an initial public offering), *cert. denied*, 423 U.S. 1087 (1976); *United States v. Persky*, 520 F.2d 283 (2d Cir. 1975) (conviction for publishing false statements in violation of rule 10b-5); *United States v. Benjamin*, 328 F.2d 854 (2d Cir.) (conviction of attorney and accountant for violating the Securities Act of 1933 and the Mail Fraud Statute), *cert. denied*, 377 U.S. 953 (1964).

115. *United States v. Natelli*, 527 F.2d 311 (2d Cir. 1975) (accountant conviction in connection with securities fraud), *cert. denied*, 425 U.S. 934 (1976); *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969) (accountants convicted for issuing audit opinion in violation of Mail Fraud and False Statement Statute and securities laws), *cert. denied*, 397 U.S. 1006 (1970).

116. In *United States v. Sarantos*, 455 F.2d 877 (2d Cir. 1972) the scienter instruction defined "knowingly and wilfully as meaning that 'one knows what he or she is doing, as distinguished from an inadvertent or careless act'" and directed that the jury could conclude Sarantos "acted with reckless disregard of whether the statements made were true or with a conscious effort to avoid learning the truth . . . even though you may find he was not specifically aware of the facts which would establish the falsity of the statements." *Id.* at 880. In *United States v. Hester*, 880 F.2d 799 (4th Cir. 1989), the Fourth Circuit held that "actual" knowledge was not needed to support a criminal conviction under 18 U.S.C. § 922(a)(6) (making a false statement in connection with the acquisition of a firearm). All that was needed was to make a statement with "a deliberate disregard for its truth or falsity with a conscious purpose to avoid learning the truth." *Hester*, 880 F.2d at 802. *Sarantos* was quoted with approval for the proposition that criminal sanctions could not be avoided by the wrongdoer's "merely closing his eyes to the obvious

Comparison of *Schatz* with SEC enforcement actions also demonstrates inconsistency in the treatment of professional conduct. SEC case law has held that attorneys with knowledge of securities law violations by their clients cannot continue their representation in the normal course, but must instead take some action, such as withdrawing from representation.¹¹⁷ Does it make sense for the very same conduct to be immune from civil liability while being subject to injunctive action or disciplinary sanction by the SEC? Or are cases like *Schatz* in fact overruling sub silentio established SEC precedent? It is impossible to square *Schatz* with the Second Circuit's ruling in *SEC v. Calvo*¹¹⁸ and the lower court decision *Calvo* affirmed.

Another anomaly created by *Schatz* and similar cases is that professionals now enjoy an immunity from liability exceeding even that of the managers they serve. Under the business judgment rule,¹¹⁹ corporate officers are relieved of liability for good faith errors of judgment. The common-law business judgment rule has never protected managers from reckless conduct, an immunity *Schatz* decrees should be given to reckless outside counsel.

b. Practical Problems Abound

Practical difficulties are raised by the tendency to bend the rules

risk he is engaging in unlawful conduct." *Id.* The Fourth Circuit did not mention *Hester* or *Sarantos* in *Schatz*. For discussion of culpability standards under the criminal law, see *infra* notes 199-294 and accompanying text.

117. *SEC v. National Student Mktg. Corp.*, 457 F. Supp. 682 (D.D.C. 1978) (liability based on furthering fraudulent proxy solicitation); *SEC v. National Student Mktg. Corp.*, 402 F. Supp. 641 (D.D.C. 1975) (denying summary judgment sought by a lawyer who claimed to have given a technically correct legal opinion; the court held that even if this were true, the SEC still would not be foreclosed from establishing aider and abettor liability); *In re Carter & Johnson*, SEC Act Release No. 17,597 [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,847, at 84,166 (Feb. 28, 1981).

118. 891 F.2d 457 (2d Cir. 1989), *aff'g* *SEC v. Electronics Warehouse, Inc.*, 689 F. Supp. 53 (D. Conn. 1988), *cert. denied*, 110 S. Ct. 3228 (1990). See *supra* notes 94-96 and accompanying text.

119. The business judgment rule creates a safe harbor for errors of judgment made in good faith by corporate directors. The rule provides a useful analogue for the solicitude shown errant opiners through the privity defense. Under the business judgment rule, directors are protected from liability unless they have acted illegally, in bad faith, engaged in fraud or self-dealing, or were guilty of gross negligence. See *Smith v. Van Gorkom*, 488 A.2d 858, 872-73 (Del. 1985) (discussing the business judgment rule and confirming that "the concept of gross negligence" embodies the proper standard of care for corporate directors). The business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. Super. Ct. 1984).

for professionals. Applying a sliding scale of scienter in a fraud case based on a securities offering, as the Fifth Circuit did in *Abell*, opens up all sorts of unresolved issues. In a real estate limited partnership offering, for example, who has a higher culpability standard: issuer's counsel, underwriters' counsel, the CPAs, the firm writing the tax opinion, or the firm that rendered the MAI appraisal? Does the scienter standard for issuer's counsel change if one of the lawyers is also a director for the issuer? Do the issuer's directors themselves have differing scienter standards depending on whether they are insiders? Does their scienter standard vary depending on how long they have served on the board? Does the lawyer for the issuer who is in charge of the engagement have a different scienter standard from the lawyer's junior partners and associates who lend important assistance?¹²⁰ In a bond offering, where would the indenture trustee or bond counsel fit into this roving-scienter-standard system? Do they deserve a higher or lower culpability standard than the managing underwriter, other underwriters, or underwriters' counsel? On what principled basis?

The sliding scale of scienter embraced by the Fifth Circuit in *Abell* will be very cumbersome and difficult to apply in practice. If ambiguity is so helpful, one wonders why the Ninth Circuit recently abandoned its "flexible duty" scienter standard in favor of a generic recklessness definition.¹²¹ This is not to say it makes more sense to go the way of jurisdictions such as the Second and Fourth Circuits that pivot the scienter standard on the existence of a fiduciary relationship between the fraud victim and the aider and abettor. For one thing, determining exactly when a fiduciary relationship exists is not always easy. For example, is a close corporation's or partnership's counsel in a fiduciary relationship with shareholders or partners? How about subscribers? Furthermore, *Schatz* suggests that a confidential relationship¹²² is the

120. Clearly, the lawyer's status within the firm may be important in deciding whether his or her conduct should be imputed to the firm. See *In re Rospatch Sec. Litig.*, 760 F. Supp. 1239, 1250 (W.D. Mich. 1991).

121. *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990), cert. denied, 111 S. Ct. 1621 (1991). In *Hollinger* the Ninth Circuit abandoned the "flexible duty" test announced in *White v. Abrams*, 495 F.2d 724, 735-36 (9th Cir. 1974). The "flexible duty" test required courts to consider the following factors: (1) the relationship of defendant to plaintiff; (2) defendant's access to the information as compared to that of plaintiff; (3) defendant's benefit derived from the relationship; (4) defendant's awareness of whether plaintiff was relying on their relationship in making his or her investment decisions; and (5) defendant's activity in initiating the transaction in question. *Zweig v. Hearst Corp.*, 594 F.2d 1261, 1268 (9th Cir. 1979).

122. According to BLACK'S LAW DICTIONARY 298 (6th ed. 1990), a confidential relation is a broad category:

A fiduciary relation. It is a peculiar relation which exists between client and attorney, principal and agent, principal and surety, landlord and tenant,

practical equivalent of a fiduciary relationship for purposes of setting the scienter standard. However, the existence of a confidential relation between parties can often be a hotly disputed issue. Thus, in many cases fact questions pertaining to the existence of a trust and confidence relationship will need to be resolved at trial as part of the scienter determination.

c. Important Policy Questions Have Been Inadequately Addressed

Schatz and the other cases upholding a recklessness-plus standard are dead wrong as a matter of policy. Analysis of the issue of the scope of professional liability for involvement in client fraud requires a balanced consideration of the policies supporting limitation of professional liability and the public interest in the integrity of securities transactions.

Pro-professional courts have articulated two policies as the bases for limiting liability of professionals in securities transactions: fear of unlimited liability imposed on the honest professional and concern about maintenance of client confidences. The first policy was articulated by Judge Cardozo in *Ultramares Corp. v. Touche*.¹²³ Cardozo refused to extend liability of professionals for negligent performance of a professional contract beyond the professional's employer to third parties. Cardozo carefully limited his decision to negligence; therefore, liability to third parties would exist when the professional engaged in fraud, including reckless conduct:

Our holding does not emancipate accountants from the consequences of fraud. It does not relieve them if their audit has been so negligent as to justify a finding that they had no genuine belief in its adequacy, for this again is fraud. It does no more than say that, if less

parent and child, guardian and ward, ancestor and heir, husband and wife, trustee and *cestui que trust*, executors or administrators and creditors, legatees, or distributees, appointor and appointee under powers, and partners and part owners. In these and like cases, the law, in order to prevent undue advantage from the unlimited confidence or sense of duty which the relation naturally creates, requires the utmost degree of good faith in all transactions between the parties. It is not confined to any specific association of parties. It appears when the circumstances make it certain that the parties do not deal on equal terms, but on the one side there is an overmastering influence, or, on the other, weakness, dependence, or trust, justifiably reposed. The mere existence of kinship does not, of itself, give rise to such relation. It covers every form of relation between parties wherein confidence is reposed by one in another, and [the] former relies and acts upon representations of the other and is guilty of no derelictions on his own part. *Peckham v. Johnson*, Tex. Civ. App., 98 S.W.2d 408, 416.

123. 255 N.Y. 170, 174 N.E. 441 (1931).

than this is proved, if there has been neither reckless misstatement nor insincere profession of an opinion, but only honest blunder, the ensuing liability for negligence is one that is bounded by the contract, and is to be enforced between the parties by whom the contract has been made. We doubt whether the average business man receiving a certificate without paying for it, and receiving it merely as one among a multitude of possible investors, would look for anything more.¹²⁴

Manipulation of the scienter element in fraud cases by an activist judiciary for social engineering purposes was never advocated by Judge Cardozo. He never suggested that professionals who act recklessly or worse are worthy of special protection. In fact, he rejected the notion. Cardozo equated reckless misconduct with fraudulent intent.¹²⁵ Yet, the cases discussed in this section have produced precisely the result Cardozo would not countenance: immunity for recklessness absent some special relationship between the professional and the victim.

The second policy basis for limiting professional liability—concern about protecting client confidences—was expressed by the Fourth Circuit in *Schatz v. Rosenberg*:

Any other result may prevent a client from reposing complete trust in his lawyer for fear that he might reveal a fact which would trigger the lawyer's duty to the third party. Similarly, if attorneys had a duty to disclose information to third parties, attorneys would have an incentive not to press clients for information. The net result would not be less securities fraud. Instead, attorneys would more often be unwitting accomplices to the fraud as a result of being kept in the dark by their clients or by their own reluctance to obtain information. The better rule—that attorneys have no duty to "blow the whistle" on their clients—allows clients to repose complete trust in their lawyers. Under those circumstances, the client is more likely to disclose damaging or problematic information, and the lawyer will more likely be able to counsel his client against misconduct.¹²⁶

124. *Id.* at 189, 174 N.E. at 448.

125. See *Harper Tax Servs. v. Quick Tax Ltd.*, 686 F. Supp. 109, 114 (D. Md. 1988): [A]llegations of either intentional or reckless misstatements state an action for fraud or deceit. The leading New York case, *Ultramares Corp. v. Touche*, 255 N.Y. 170, 174 N.E. 441 (1931), resisted a trend to recognize parallel negligence and fraud actions by accepting a broader view of the latter: 'Fraud includes the pretense of knowledge when knowledge there is none. . . . If such a statement was made, whether believed to be true or not, the defendants are liable for deceit in the event that it was false.' *Id.* at 179-80, 174 N.E. at 444. "Even the narrowest holdings as to liability for unintentional misstatement concede that a representation in such circumstances may be equivalent to a warranty." *Id.* at 183, 174 N.E. at 446.

Id.

126. 943 F.2d 485, 493 (4th Cir. 1991).

The Seventh Circuit in *DiLeo v. Ernst & Young*¹²⁷ expressed similar concerns about requiring auditors to “blow the whistle on improper behavior by their clients.”¹²⁸

Such a duty would prevent the client from reposing in the accountant the trust that is essential to an accurate audit. Firms would withhold documents, allow auditors to see but not copy, and otherwise emulate the CIA, if they feared that access might lead to destructive disclosure—for even an honest firm may fear that one of its accountant’s many auditors would misunderstand the situation and ring the tocsin needlessly, with great loss to the firm.¹²⁹

Protecting attorney-client privileged communications is not a legitimate concern in cases where a prima facie case can be made that the lawyer’s services have been used to further a fraud. Courts consistently have recognized that the attorney-client privilege is limited by a “crime-fraud exception,” making it inapplicable where the lawyer’s consultation assists the client in committing a continuing or future crime, fraud, or other misconduct,¹³⁰ or in obstructing discovery of a past fraud.¹³¹ The policy underlying the crime-fraud exception was explained by the Second Circuit:

The rationale for the exclusion is closely tied to the policies underlying these privileges. Whereas confidentiality of communications and

127. 901 F.2d 624 (7th Cir.), *cert. denied*, 111 S. Ct. 347 (1990).

128. *Id.* at 629.

129. *Id.* History has shown that accountants’ clients bent on perpetrating financial fraud have long been prone to use clandestine tactics, including withholding documents “and otherwise emulat[ing] the CIA,” which is why auditors exist in the first place. A client who prevented its accounting firm from conducting the audit in accordance with generally accepted accounting standards would receive an opinion qualified as to scope, a red flag itself, full of meaning to creditors and regulatory agencies, including the SEC. In *United States v. Arthur Young & Co.*, 465 U.S. 819 (1984), the Supreme Court unanimously rejected the argument that accountants were entitled to special preferential treatment (protection of tax accrual work papers from IRS scrutiny) premised on the fear that absent special protection “a corporation might be tempted to withhold from its auditor certain information relevant and material to a proper evaluation of its financial statements.” *Id.* at 818. *DiLeo* thus simply recycles the already discredited argument that if auditors do what they are expected to do—audit diligently and report fairly and honestly—the system will somehow suffer grave injury. *Schatz* recycles the infirm argument packaged in pro-lawyer verbiage.

130. *See, e.g., In re Sealed Case*, 754 F.2d 395, 399 (D.C. Cir. 1985); *In re Special September 1978 Grand Jury (II)*, 640 F.2d 49, 59 (7th Cir. 1980); *United States v. Aldridge*, 484 F.2d 655, 658 (7th Cir. 1973), *cert. denied*, 415 U.S. 921 (1974); *Sound Video Unlimited, Inc. v. Video Shack, Inc.*, 661 F. Supp. 1482 (N.D. Ill. 1987). *See generally Developments in the Law—Privileged Communications*, 98 HARV. L. REV. 1450, 1509-14 (1985).

131. *See, e.g., In re John Doe Corp.*, 675 F.2d 482, 491 (2d Cir. 1982); *Grand Jury (II)*, 640 F.2d at 60-61.

work product facilitates the rendering of sound legal advice, advice in furtherance of a fraudulent or unlawful goal cannot be considered "sound." Rather advice in furtherance of such goals is socially perverse, and the client's communications seeking such advice are not worthy of protection.¹³²

If rendering advice in furtherance of a client's fraud is socially perverse, what can be said about a lawyer's knowingly assisting the fraud by papering the deal and splitting the proceeds with the client? Thus, one problem with the confidentiality concern raised in the cases is that confidentiality never has been protected where the lawyer's employment is an essential link in the fraudulent scheme.

Moreover, the professed confidentiality concerns miss the point when the basis of liability asserted against the professional is knowing or reckless assistance in fraud rather than primary liability for failure to blow the whistle. Even if one accepts the proposition that the securities laws do not impose direct liability for failure to disclose information absent a fiduciary duty or similar duty of trust and confidence,¹³³ this doctrine does not justify connivance. Confidences can be maintained without complicity if professionals follow a simple formula when confronted with client fraud: counsel against the fraud, then withdraw if necessary.¹³⁴

Missing from *Schatz* is any cogent explanation how the policy balance struck tilts in society's best interest. Exactly what societal value is served by permitting professionals, holding monopoly licenses and sworn to serve in the public interest, to knowingly or recklessly aid their corrupt clients in fleecing innocent reliant parties? If lawyers are privileged knowingly or recklessly to prepare and present fraudulent financial documents used to dupe private investors, then what about when the recipients are federal banks or government agencies? Exactly what longstanding, honorable precept of the legal profession is served by allowing its members to knowingly or recklessly further frauds perpetrated on innocent investors? How does the protection from accountability given reckless lawyers who aid frauds on public investors compare with the high level of professionalism and accountability federal judges demand from those same lawyers as evidenced by Rule 11?¹³⁵

132. *In re Grand Jury Subpoena Duces Tecum* Dated September 15, 1983, 731 F.2d 1032, 1038 (2d Cir. 1984).

133. The Supreme Court accepted this view in *Chiarella v. United States*, 445 U.S. 222 (1980).

134. See *SEC v. National Student Mktg. Corp.*, 457 F. Supp. 682 (D.D.C. 1978); *SEC v. National Student Mktg. Corp.*, 402 F. Supp. 641 (D.D.C. 1975); *In re Carter & Johnson*, SEC Act Release No. 17,597 [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,847, at 84,166 (Feb. 28, 1981).

135. FED. R. CIV. P. 11.

How does immunizing knowing or reckless assistance to fraudulent conduct, the precise misconduct condemned in numerous leading securities cases,¹³⁶ enhance either confidence in America's capital markets or the public's trust in the legal profession?

Another serious public policy problem surfaces once courts seek to protect miscreants toiling within the workings of complex fraudulent schemes. Fraudulent schemes outlawed by both RICO and 10b-5 can assume enormous size. The truly large ones tend to be hatched or furthered by those who operate out of the individual investors' view. Consequently, the more emphasis placed on the defendant's physical contacts or direct dealings or trust and confidential relationship with the plaintiff in a case attacking a fraudulent scheme, the greater the likelihood that scienter will be hardest to show where proving it is most important: in the truly massive, complicated, nationwide scam having layers of wrongdoers and hundreds or thousands of injured investors.¹³⁷ As the size of the swindle, and hence its viciousness, escalates, the physical contacts between victims and those in control are apt to decrease or be nonexistent. Is it reasonable to insist in such cases that, as the contacts between victims and miscreants diminish or disappear, the victim's burden of proof on intent ought to rise to the level of practical impossibility?

d. Summary

The Second, Fourth, Fifth, and Seventh Circuits are leading the way toward formulation of an extremely high culpability standard applicable to white collar fraud participants who "merely 'papered the

136. *E.g.*, *United States v. Frank*, 520 F.2d 1287 (2d Cir. 1975) (conviction of securities lawyer for conspiracy to violate the securities laws in connection with an initial public offering), *cert. denied*, 423 U.S. 1087 (1976); *United States v. Persky*, 520 F.2d 283 (2d Cir. 1975) (conviction for publishing false statements in violation of Rule 10b-5); *United States v. Benjamin*, 328 F.2d 854 (2d Cir.) (convictions for violating the Securities Act of 1933 and the mail fraud statute), *cert. denied*, 377 U.S. 953 (1964). *See also supra* note 115.

137. For example, in *Faircloth v. Finesod*, 938 F.2d 513 (4th Cir. 1991), the court dealt with an "art master scam," *id.* at 515 n.2, involving 2000 sales of fraudulent tax shelters, that generated "\$409 million in notes receivable from buyers of art masters." *Id.* at 514. The art master company, Jackie Fine Arts, Inc., was wholly owned by a holding company that was in turn wholly owned by the fraud's promoter, Herman Finesod. The holding company's 1986 tax return showed assets of \$1.33 billion. *Id.* at 514 n.1. In a huge fraudulent scheme like this, what is the likelihood that a particular investor will be in actual contractual privity with, or specifically rely on, or even know the names of those professionals working for the promoter who are instrumental in bringing the scam to fruition? Why should the promoter's lawyers, who operate anonymously behind the scenes as the legal architects of the scheme, be held to a more relaxed scienter standard than the firm that writes the tax shelter opinion packaged in the sales literature?

deal,'¹³⁸ however cunning and fraudulent that deal may be. Fabrication of a higher culpability standard translates as well into tolerance, if not outright approval, of a lower standard of professional behavior. The reckless professional, if not applauded, is at least protected.

Insofar as there is a tendency, however insupportable, to raise culpability standards when professionals are attacked by use of aider and abettor or co-conspirator allegations, there is an obvious alternative. The alternative is to not sue based on a theory of indirect liability, but to sue the professional as a direct participant in a fraudulent scheme. Rule 10b-5's text clearly supports this tack since it outlaws not just making material misrepresentations and omissions, but also employing "any device, scheme, or artifice to defraud," and engaging in "any act or practice or course of business which operates or would operate as a fraud or deceit upon any person."¹³⁹ The rule's wording certainly does not condone a lawyer's preparation and participation in the use of fraudulent documents created to facilitate the purchase of a company's control stock. Nor does the rule's language require that the 10b-5 violator communicate directly with the victim, though conservative courts bent on truncating the rule's reach have so interpreted it.¹⁴⁰ Civil RICO likewise has no written requirement that violators communicate directly with RICO victims. It reaches those who "conduct or participate . . . in the conduct of [an] enterprise's affairs,"¹⁴¹ thereby creating a basis for a direct civil claim.

The policy choices made in *Schatz* and like cases bring to mind the observation found in a leading California lawyer malpractice case, *Neel v. Magana, Olney, Levy, Cathcart & Gelfand*.¹⁴² In that case the California Supreme Court brought the law covering tolling of limitations periods in suits against lawyers into line with standards covering other service providers, saying:

[I]n our complex and interdependent society, human relations are

138. *Schatz v. Rosenberg*, 943 F.2d 485, 495 (4th Cir. 1991).

139. 17 C.F.R. § 240.10b-5(1) & (3) (1990).

140. For example, the Fourth Circuit in *Schatz* explained:

To state a claim for a primary violation of Section 10(b) and Rule 10b-5, a plaintiff must allege that the defendant (1) made an untrue statement of material fact or omitted a material fact that rendered the statements misleading, (2) in connection with the purchase or sale of a security, (3) with scienter, and (4) which caused the plaintiff's losses.

Schatz, 943 F.2d at 489 (citing *Schlifke v. Seafirst Corp.*, 866 F.2d 935, 943 (7th Cir. 1989)). This approach erroneously treats Rule 10b-5(2), which outlaws material misrepresentations and omissions, as if it is the entire rule.

141. 18 U.S.C. § 1962(c) (1988).

142. 6 Cal. 3d 176, 491 P.2d 421, 98 Cal. Rptr. 837 (1971).

ever being further fit into a framework of legal rights and responsibilities, and, in this process, the role of the lawyer has become increasingly crucial. As more individuals come to depend upon him, his responsibility must broaden and deepen. . . . The legal calling can ill afford the preservation of a privileged protection against responsibility¹⁴³

Evidently, a growing number of federal circuit courts believe that the establishment of a privileged protection from responsibility is just what the legal profession needs and deserves.¹⁴⁴ At some point, 10b-5 scienter standards will again need to be revisited by the Supreme Court.¹⁴⁵ When that re-examination is made in the context of standards applicable to professionals, the Court must confront and resolve the grave logical, practical, and policy questions mentioned above.

III. PLEADING SCIENTER IN CIVIL SUITS AGAINST PROFESSIONALS

A. *Scope, Requirements, and Purpose of Rule 9(b)*

The first defensive move apt to be considered on behalf of a professional attacked in a civil suit alleging deception is the motion to dismiss. If the suit asserts something resembling a fraud claim, the defense will consider responding with a motion contending the plaintiff has failed to plead fraud with the requisite particularity. The source of this contention in federal courts is Federal Rules of Civil Procedure (FRCP) 9(b). Rule 9(b) demands that “the circumstances constituting fraud . . . shall be stated with particularity.”¹⁴⁶ It also provides that “intent . . . and other conditions of mind of a person may be averred generally.”¹⁴⁷

Securities fraud and civil RICO claims premised on mail fraud, wire fraud, or securities fraud¹⁴⁸ are covered by Rule 9(b), as are allegations of aiding and abetting fraud¹⁴⁹ or conspiring to defraud.¹⁵⁰ Where

143. *Id.* at 194, 491 P.2d at 432-33, 98 Cal. Rptr. at 848-49.

144. And perhaps the accounting profession as well.

145. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) is the leading case. *Hochfelder* was an appeal from a Seventh Circuit decision holding that auditors could negligently aid and abet 10b-5 fraud.

146. FED. R. CIV. P. 9(b).

147. *Id.*

148. *E.g.*, *DiVittorio v. Equidyne Extractive Indus.*, 822 F.2d 1242, 1247 (2d Cir. 1987); *Ross v. A.H. Robins Co.*, 607 F.2d 545, 557 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980); *Gutman v. Equidyne Extractive Indus.*, 769 F. Supp. 121 (S.D.N.Y. 1991); *Curtis v. Duffy*, 742 F. Supp. 34 (D. Mass. 1990); *Burt v. Danforth*, 742 F. Supp. 1043 (E.D. Mo. 1990); *Cruse v. Equitable Sec. of N.Y., Inc.*, 678 F. Supp. 1023 (S.D.N.Y. 1987).

149. *E.g.*, *Andreo v. Friedlander, Gaines, Cohen, Rosenthal & Rosenberg*, 651 F.

there are multiple defendants, the complaint must allege the specific nature of each defendant's participation in the fraud.¹⁵¹ Not reached by Rule 9(b) are claims alleging a nonfraudulent breach of fiduciary duty,¹⁵² conversion, unjust enrichment, "gross or culpable negligence,"¹⁵³ and undue influence.¹⁵⁴

Rule 9(b)'s text posits two sides to a fraud allegation: intent and everything else. In the context of the hornbook elements of fraud, misrepresentation of a material fact, falsity of the representation, reliance, damages, and scienter,¹⁵⁵ this means that the underlying facts supporting the first four need to be spelled out in detail.

It has been said that Rule 9(b) was created to further "three goals: providing a defendant fair notice of the plaintiff's claim, to enable preparation of a defense; protecting a defendant from harm to his reputation or goodwill as a result of loose charges of fraud and deceit; and reducing the number of strike suits."¹⁵⁶

Complying with the spirit of the particularity requirement under the rule should not be overly difficult, so long as Rule 9(b) is read in conjunction with Rule 8. Rule 8(a) calls for pleadings to set forth "a short and plain statement of the claim showing the pleader is entitled to relief,"¹⁵⁷ and Rule 8(e)(1) demands that "[e]ach averment . . . of a

Supp. 877, 880 (D. Conn. 1986); *In re Cincinnati Gas & Elec. Sec. Litig.*, 594 F. Supp. 233, 237 (S.D. Ohio 1984).

150. *E.g.*, *Security Pac. Equip. Leasing, Inc. v. Earthworm Tractor Co.*, 1990 WL 96757 (S.D.N.Y. July 3, 1990) (WESTLAW); *Burt*, 742 F. Supp. at 1051 ("[P]laintiff's allegations of mail and wire fraud, false proxy statements, violations of the Foreign Corrupt Practices Act and defendants' conspiracy to conceal wrongdoing are wholly insufficient under Rule 9(b)."); *Roberts v. Heim*, 670 F. Supp. 1466, 1484 (N.D. Cal. 1987), *aff'd in part, rev'd in part sub nom. Roberts v. Peat, Marwick, Mitchell & Co.*, 857 F.2d 646 (9th Cir. 1988), *cert. denied*, 110 S. Ct. 561 (1989). *But see Hecht v. Commerce Clearing House, Inc.*, 897 F.2d 21, 26 n.4 (2d Cir. 1990) ("On its face, Rule 9(b) applies only to fraud or mistake"; thus plaintiff's "pleading of conspiracy apart from the underlying acts of fraud is properly measured under the more liberal pleading requirements of Rule 8(a).").

151. *DiVittorio*, 822 F.2d at 1247; *Block v. First Blood Assocs.*, 743 F. Supp. 194 (S.D.N.Y. 1990).

152. *Robison v. Caster*, 356 F.2d 924, 925 (7th Cir. 1966); *Zucker v. Katz*, 708 F. Supp. 525 (S.D.N.Y. 1989). However, a suit alleging a fraudulent breach of fiduciary duty is within Rule 9(b).

153. *Burt v. Danforth*, 742 F. Supp. 1043 (E.D. Mo. 1990).

154. *Medeiros v. John Alden Life Ins. Co.*, 1990 WL 115606 (S.D.N.Y. Aug. 10, 1990) (WESTLAW).

155. *E.g.*, *Mallis v. Bankers Trust Co.*, 615 F.2d 68, 80 (2d Cir. 1980), *cert. denied*, 449 U.S. 1123 (1981); *Smith v. Kurtzman*, 176 Ill. App. 3d 840, 846, 531 N.E.2d 885, 889 (1988).

156. *In re Union Carbide Corp. Consumer Prods. Business Sec. Litig.*, 666 F. Supp. 547, 558 (S.D.N.Y. 1987).

157. FED. R. Civ. P. 8(a).

pleading shall be simple, concise and direct.”¹⁵⁸ What the drafters contemplated as a sufficient fraud allegation within Rules 8 and 9 is evidenced by Form 13.¹⁵⁹

That form shows how to allege a demand to set aside a debtor’s transfer of assets based on fraud: “Defendant C.D. . . . conveyed all his property . . . to defendant E.F. for the purpose of defrauding plaintiff”¹⁶⁰ Form 13’s allegation of fraud obviously is “short and plain,” as well as “simple, concise, and direct.” It also presents a manner of pleading that would be tossed out of court in a heartbeat by many judges called on to assess similarly succinct allegations of fraud made against professionals accused of furthering a business fraud.

B. Heightened Requirements for Pleading Scienter Under Rule 9(b)

It is becoming increasingly difficult to allege satisfactorily fraudulent intent in federal suits involving accountant or lawyer misconduct. The Second Circuit and its district courts impose strict pleading requirements on state of mind allegations in business fraud actions.¹⁶¹ In

158. *Id.* 8(e).

159. FED. R. CIV. P. Appendix of Forms, Form 13. Under Rule 84, the allegations set forth in the forms expressly are deemed “sufficient under the rules and are intended to indicate the simplicity and brevity of statement which the rules contemplate.” FED. R. CIV. P. 84.

160. FED. R. CIV. P. Appendix of Forms, Form 13.

161. *See e.g.*, *Wexner v. First Manhattan Co.*, 902 F.2d 169, 172 (2d Cir. 1990) (“great specificity” not required, but the facts alleged must provide a “strong inference” of fraudulent intent); *Cosmas v. Hassett*, 886 F.2d 8, 13 (2d Cir. 1989) (“To satisfy the scienter requirement, a plaintiff need not allege facts which show the defendants had a motive for committing fraud, so long as the plaintiff . . . adequately identifies circumstances indicating conscious behavior by the defendants.”); *Beck v. Mfrs. Hanover Trust Co.*, 820 F.2d 46, 50 (2d Cir. 1987) (requiring a factual basis for conclusory allegations of scienter), *cert. denied*, 484 U.S. 1005 (1988); *Connecticut Nat’l Bank v. Fluor Corp.*, 808 F.2d 957, 962 (2d Cir. 1987) (observing that while scienter allegations do not need to be made with “great specificity,” plaintiffs must “provide at least a minimal factual basis for their conclusory allegations of scienter”); *Luce v. Edelstein*, 802 F.2d 49, 57 (2d Cir. 1986) (demanding allegation of particular facts demonstrating defendants’ knowledge they were making misrepresentations at the time the statements were made); *Bamco 18 v. Reeves*, 675 F. Supp. 826 (S.D.N.Y. 1987) (factual basis for state of mind allegations necessary); *Dannenberg v. Dorison*, 603 F. Supp. 1238, 1241 (S.D.N.Y. 1985) (alleging that defendant participated in numerous transactions branded as fraudulent, without pleading facts that would permit an inference of knowledge that any of these transactions was fraudulent, is insufficient to state a claim for fraud).

Demonstrating the gulf in the Second Circuit between pleading misrepresentations and scienter is *Wexner*:

There is no question that *Wexner* has adequately identified the statements alleged to be misrepresentations and properly indicated when, where and by

*Ross v. Bolton*¹⁶² the court showed a willingness to back-door a specific pleading requirement for state of mind by reference to other matters: "The time, place, and nature of the misrepresentations must be set forth so that the defendant's intent to defraud, to employ any scheme or artifice to defraud, to make any untrue statement of a material fact, or to engage in any act or course of business that would operate as a fraud under the securities laws is revealed."¹⁶³

Of course, this is sheer nonsense. First, because misrepresentations may have been made does not necessarily reveal anything about the speaker's state of mind. The mere fact that a specific statement, report, or opinion was wrong and relied upon does not mean it was not the product of an innocent or, at worst, negligent blunder. Second, whether the defendant had fraudulent intent is something already known to the defendant, who will deny its existence in any event. The defendant does not need his supposed intent revealed in order to frame a responsive pleading. Third, the complaint is not evidence and does not go to the jury. Disclosing proof of the defendant's intent in the complaint does not help the trier of fact do anything.

A recent pro-defense pleading case involving professionals is *O'Brien v. National Property Analysts Partners*,¹⁶⁴ a tax shelter fraud class action. The Price Waterhouse accounting firm was one of "more than sixty named and unnamed defendants"¹⁶⁵ sued under the federal securities laws and civil RICO. All defendants settled, except for the

whom they were made. See *Cosmas v. Hassett*, 886 F.2d 8, 11 (2d Cir. 1989). The amended complaint nonetheless fails to allege circumstances that give rise to a strong inference that the defendants knew the statements to be false. See *Ouaknine*, 897 F.2d at 79-80.

902 F.2d at 173.

162. 904 F.2d 819 (2d Cir. 1990).

163. *Id.* at 823. According to a Second Circuit District Court judge:

Rule 9(b) will be satisfied if the complaint specifies the following:

(1) precisely what statements were made in what documents or oral representations or what omissions were made, and (2) the time and place of each such statement and the person responsible for making (or, in the case of omissions, not making) the same, (3) the content of such statements and the manner in which they misled the plaintiff, and (4) what the defendants "obtained as a consequence of the fraud."

Conan Properties, Inc. v. Mattel, Inc., 619 F. Supp. 1167, 1172 (S.D.N.Y. 1985).

The Seventh Circuit is in accord. As that court recently observed: "Although states of mind [intent] may be pleaded generally, the 'circumstances' must be pleaded in detail. This means the who, what, when, where and how: the first paragraph of any newspaper story." *DiLeo v. Ernst & Young*, 901 F.2d 624, 627 (7th Cir.), *cert. denied*, 111 S. Ct. 347 (1990).

164. 719 F. Supp. 222 (S.D.N.Y. 1989), *dismissal aff'd* by 936 F.2d 674 (2d Cir. 1991).

165. *Id.* at 224.

accounting firm and one other defendant. En route to dismissing all claims against the accounting firm, the court noted that “[p]laintiffs proffer only conclusory allegations as to Price Waterhouse’s state of mind.”¹⁶⁶ The court also observed that “[w]hile scienter need not be alleged with great specificity,” plaintiffs must “specifically plead those events which give rise to a strong inference that defendants had an intent to defraud, knowledge of falsity, or a reckless disregard for the truth.”¹⁶⁷ According to the court, when an accountant’s work product is attacked as fraudulent, the plaintiff is required to “allege particular facts demonstrating the knowledge of defendants *at the time* that such statements were false.”¹⁶⁸ The court also held that the knowledge element of a fraud claim based on aider and abettor status needs to be alleged with particularity.¹⁶⁹

None of the *O’Brien* court’s rulings on pleading state of mind can be squared with Rule 9(b)’s language. If, as Rule 9(b) promises, “intent . . . and other condition of mind . . . may be averred generally,”¹⁷⁰ then why were the plaintiffs’ state of mind allegations in *O’Brien* dismissed as conclusory? Where in the rule is the mandate to plead scienter with any specificity? Where does the rule require facts to be pleaded demonstrating that defendants knew they were making false representations? At least the court in *O’Brien* frankly stated the reason for adopting special pleading requirements not justified by Rule 9(b)’s text: “Rule 9(b) is especially designed to protect the reputation of . . . professionals from injury caused by unsubstantiated charges of fraud.”¹⁷¹

Similarly, in *Breard v. Sachnoff & Weaver, Ltd.*¹⁷² the district court noted that the particularity requirements of Rule 9(b) “are especially applicable to a complaint charging a lawyer with fraud in connection with an offering memorandum.”¹⁷³ The court also held that Rule 9(b) “mandates that a plaintiff meet a higher standard of pleading fraud as it relates to attorneys.”¹⁷⁴ This reading of Rule 9(b) showed

166. *Id.* at 228.

167. *Id.*

168. *Id.* (quoting *DiVittorio v. Equidyne Extractive Indus., Inc.*, 822 F.2d 1242, 1248 (2d Cir. 1987)).

169. *Id.* n.9.

170. FED. R. CIV. P. 9(b).

171. *O’Brien v. National Property Analysts Partners*, 719 F. Supp. 222, 227 (S.D.N.Y. 1939) *dismissal aff’d* by 936 F.2d 674 (2d Cir. 1991). *See also* *Griffin v. McNiff*, 744 F. Supp. 1237, 1246 (S.D.N.Y. 1990) (“[A] charge of fraud against a law firm should not lightly be inferred.”).

172. RICO Bus. Disp. Guide (CCH) ¶ 11,191 (S.D.N.Y.), *rev’d*, 941 F.2d 142 (2d Cir. 1991).

173. *Id.* ¶ 11,193.

174. *Id.*

nothing but unvarnished pro-lawyer bias, and proved to be too much for even the Second Circuit, which reversed. The appellate court adhered to its view that a factual basis for scienter needed to be alleged, but found that it had been.

The facts held to show scienter were based on the defendant law firm's having (1) drafted an initial limited offering memorandum that failed to disclose that the venture's chief financier and guarantor, John Berg, had been convicted for mail fraud and conspiracy in connection with a previous limited partnership offering which featured a similar financing arrangement, and (2) drafted a revised offering memorandum that mentioned the conviction, but failed to disclose the nature of the fraud, the fact that the past and present financings were very similar, and opined that Berg's past criminal activity would not be material to an investment in the new venture.¹⁷⁵ The defendant law firm was faulted on two counts. The Second Circuit viewed the failure to mention the conviction in the first offering memorandum as reckless as a matter of law. The court also faulted the lawyers for expressing an adverse opinion on materiality without having attempted to investigate the underlying facts. On this score it quoted with approval the principle that "[a]n egregious refusal to see the obvious, or to investigate the doubtful, may in some cases give rise to an inference of recklessness."¹⁷⁶ The court thus was willing to equate "willful blindness" or "conscious avoidance" with recklessness. As will be seen in the following section, conscious avoidance can provide not only evidence of recklessness, but of knowledge itself.

The district court's willingness to dismiss the complaint as a matter of law in *Breard*, in the face of a record raising an inference of very serious misconduct, shows how far some courts are willing to go to protect wayward professionals. Although it reversed, the Second Circuit specifically adhered to prior precedent demanding that plaintiffs in federal fraud cases "allege sufficient facts giving rise to a strong inference of fraudulent intent."¹⁷⁷

The Seventh Circuit appears to be joining the Second Circuit in adding a stringent pleading requirement for state of mind. In *DiLeo v. Ernst & Young*,¹⁷⁸ the court observed:

Although Rule 9(b) does not require "particularity" with respect to the defendants' mental state, the complaint still must afford a basis for believing that plaintiffs could prove scienter. *Barker* observed, 797

175. *Breard v. Sachnoff & Weaver, Ltd.*, 941 F.2d 142, 144 (2d Cir. 1991).

176. *Id.* (citing *Goldman v. McMahan, Brafman, Morgan & Co.*, 706 F. Supp. 256, 259 (S.D.N.Y. 1989)).

177. *Id.* at 145.

178. 901 F.2d 624 (7th Cir.), *cert. denied*, 111 S. Ct. 347 (1990).

F.2d at 497, that the case “against an aider, abettor, or conspirator may not rest on a bare inference that the defendant ‘must have had’ knowledge of the facts. The plaintiff must support the inference with some reason to conclude that the defendant has thrown in his lot with the primary violators.”¹⁷⁹

The Seventh Circuit also noted that professionals who receive a normal fee for their services would be behaving irrationally to aid and abet a fraud, thereby risking mammoth damages.¹⁸⁰ Furthermore, the court made clear its pro-professional leaning by adding: “One who believes that another has behaved irrationally has to make a strong case.”¹⁸¹

Another means used to throttle fraud suits is to limit the use of allegations made on information and belief.¹⁸² Such allegations are permitted only when the facts alleged “are peculiarly within the opposing party’s knowledge,”¹⁸³ and, even then, the complaint must set forth the source of the information and the reasons for the belief,¹⁸⁴ and the specific facts that are alleged must support a strong inference of fraud.¹⁸⁵

C. *Justifications for Heightened Pleading Requirements*

An evident preoccupation with deterring strike suits in securities¹⁸⁶ and civil RICO¹⁸⁷ cases has led some courts to demand specific-

179. *Id.* at 629.

180. *Id.*

181. *Id.* The complaint was faulted for failing to name any auditor “or explain what that person might have had to gain for covering up Continental’s wrongs.” *Id.*

182. *E.g.*, *Luce v. Edelstein*, 802 F.2d 49, 54 n.1 (2d Cir. 1986).

183. *Id.* (quoting *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 379 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975)).

184. *E.g.*, *New England Data Serv., Inc. v. Becher*, 829 F.2d 286, 288 (1st Cir. 1987).

185. *Wexner v. First Manhattan Co.*, 902 F.2d 169, 172 (2d Cir. 1990).

186. A bias against securities claims was revealed recently by a Second Circuit District Court opinion: “[I]n a securities context, Rule 9(b) acts as a disincentive to the large number of plaintiffs with groundless claims who prosecute charges with the knowledge that there still might be some settlement value at the end of the line. Such suits are often given the demeaning sobriquet ‘strike suits.’” *McCoy v. Goldberg*, 748 F. Supp. 146, 155 (S.D.N.Y. 1990) (emphasis added). The opinion reveals no empirical support for its suggestion that the courts are besieged by litigants bent on bringing frivolous securities actions. Nor is there any sign of large numbers of publicly reported ethics disciplinary actions against lawyers for assisting such misconduct, whether instituted by federal district court judges or otherwise. Nor is there any explanation why Rule 11 does not adequately address the problem.

The willingness of Second Circuit courts to warp the requirements of Rule 9(b) has not gone unnoticed. In *Jackson v. First Fed. Sav.*, 709 F. Supp. 863 (E.D. Ark. 1988), the Arkansas District Court expressly declined to follow a line of Rule 9(b) cases from the Southern District of New York, suggesting the results were skewed because the Second Circuit, “has been most concerned with deterring strike suits in securities cases.” *Id.* at 879 n.12.

ity in allegations of intent. Summarizing these developments, an eminent authority states that a number of courts recently have "shown a tendency to be more demanding in their application of Rule 9(b),"¹⁸⁸ particularly in securities fraud and civil RICO cases, concluding that "[t]hese cases undoubtedly reflect a reaction to the increased numbers of these cases and the desire to filter out frivolous cases."¹⁸⁹ Accepting this as true raises the question whether an increase in suits filed furnishes any justification for changing pleading requirements purely by means of judicial construction. Cogent attacks on courts' overly demanding applications of Rule 9(b) can be and have been made, particularly in the context of complex business fraud.¹⁹⁰ Nowhere in the Federal Rules of Civil Procedure does any authorization for a sliding scale of judicial scrutiny of claims exist based on the frequency with which claims are asserted or the perceived pique of the targeted defendants. In truth, Rule 9(b)'s own text, allowing general averments of intent, "recognizes that any attempt to require specificity in pleading a condition of mind would be unworkable and undesirable."¹⁹¹

As for the second justification for new-found judicial toughness—concern about frivolous suits—it is fair to ask why the gatekeeper function is performed better under Rule 9(b) than Rule 11, given that Rule 11 allows courts to impose sanctions on lawyers who assert frivolous claims.¹⁹² Would not a fine send a more potent message

187. Alarm over RICO actions has no doubt spooked some courts, driving them to toughen pleading standards. In *Plount v. American Home Assurance Co.*, 668 F. Supp. 204 (S.D.N.Y. 1987), the court eyed the "flood of cases under the RICO label" and concluded that "all of the concerns that dictate that fraud be pleaded with particularity exist with *even greater urgency* in civil RICO actions" *Id.* at 206 (emphasis added).

188. C. WRIGHT & A. MILLER, *FEDERAL PRACTICE AND PROCEDURE: CIVIL* § 1297, AT 613-14 (2d ed. 1990) [HEREINAFTER WRIGHT & MILLER].

189. *Id.* at 614.

190. See Richman, Lively & Mell, *The Pleading of Fraud: Rhymes Without Reason*, 60 S. CAL. L. REV. 959 (1987).

191. Wright & Miller, *supra* note 188, § 1301, at 674. As the authors explain: It would be unworkable because of the difficulty inherent in describing a state of mind with exactitude and because of the complexity and prolixity that any attempt to support these averments by setting forth all the evidence on which they are based would introduce into pleadings

It might be argued that the second sentence in Rule 9(b) is unnecessary, since it merely restates the content of Rule 8(a)(2). However, its placement in Rule 9(b) suggests that the draftsmen felt a need to qualify the first sentence of the rule and thus insure that the latter was not interpreted to require a party pleading fraud or mistake to allege specifically the circumstances from which fraudulent intention, knowledge of the falsity of a statement, or mistaken belief in its truth could be inferred.

Id. at 674-76.

192. Moreover, as one district court has noted, "[t]he high cost of maintaining con-

to the offending lawyer than a dismissal order, particularly since dismissals under Rule 9(b) “are almost always” given with leave to amend?¹⁹³ The threat of sanctions under Rule 11 likewise serves to safeguard defendants’ reputations from unfair attack. Alternatively, would not a judge’s filing of a grievance with state ethical authorities obtain the offending lawyer’s attention?¹⁹⁴ The ready application of both monetary and ethical sanctions casts doubt on the need for courts to alter pleading requirements to protect defendants in certain cases.

D. Conclusion

The Rule 9(b) cases show that a lawyer who drafts a fraud complaint against a professional relating to an alleged fraudulent scheme should presume the facts alleged will need to provide an inference of scienter for each defendant. Facts should be presented showing either motive or circumstances indicating conscious behavior, including willful blindness, linking each defendant to the alleged fraud.¹⁹⁵ Diligent factual investigation must be undertaken to ascertain what the professionals knew, what was knowable, and what may have been deliberately disregarded. Experts familiar with transactions of the nature involved should be consulted for their views on what the professionals did, must have done, should have done, or could have done.¹⁹⁶

However, complying with these suggestions for achieving factual specificity may become increasingly difficult. It is reasonable to question whether some judges’ displeasure over the quantity and quality of business fraud filings is not self-validating. Judicial antipathy toward meritless cases breeds higher standards, will generate more dismissals,

tingent fee litigation has largely eliminated” the strike suit “peril” addressed by Rule 9(b). *In re Union Carbide Consumer Prods. Business Sec. Litig.*, 666 F. Supp. 547, 558 (S.D.N.Y. 1987).

193. *Luce v. Edelstein*, 802 F.2d 49, 56 (2d Cir. 1986); *Yoder v. Orthomolecular Nutrition Inst., Inc.*, 751 F.2d 555, 562 n.6 (2d Cir. 1985).

194. Judges, as lawyers, have an ethical obligation to report lawyers who file frivolous claims to disciplinary authorities. MODEL CODE OF PROFESSIONAL RESPONSIBILITY EC 7-4 (1980), provides in part: “[A] lawyer is not justified in asserting a position in litigation that is frivolous.” See also *id.* DR 7-102(A)(1), (2), (5). The ABA’s Model Rules of Professional Conduct demand that: “A lawyer shall not bring . . . a proceeding, or assert . . . an issue therein, unless there is a basis for doing so that is not frivolous.” MODEL RULES OF PROFESSIONAL CONDUCT Rule 3.1 (1983). The mandatory obligation for judges who are lawyers to turn in offending lawyers stems from the Code’s DR 1-103(A) and Model Rule 8.3(a). For a rare example of a court reporting a lawyer before it to an ethics tribunal, see *Greycas v. Proud*, 826 F.2d 1560, 1568 (7th Cir. 1987), *cert. denied*, 484 U.S. 1043 (1988).

195. *E.g.*, *Cosmas v. Hassett*, 886 F.2d 8, 13 (2d Cir. 1989).

196. For factors to be evaluated in assembling factual allegations regarding the scienter issue, see *infra* notes 295-343 and accompanying text.

and will result, one may expect, in more antipathy. In the face of this, promoters of fraudulent ventures would be remiss if they did not bury forum selection clauses in their subscription agreements, trapping luckless investors around the country into suing in hostile forums.

Adding to the pressure facing a lawyer called on to draft a 10b-5 complaint attacking professionals believed to have furthered a massive fraud is the Supreme Court's recent ruling in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*.¹⁹⁷ In this case the Court held that a 10b-5 suit must be filed within one year of discovery of facts constituting the violation, with an absolute three-year statute of repose. *Lampf* and the pleading cases discussed in this section create a tightening vise on plaintiffs' counsel. A short statute of limitations coupled with stonewalling tactics commonly used by fraudfeasors in response to their victims' requests for information make it difficult for prospective plaintiffs to gather facts; at the same time courts increasingly are throwing cases out of court for lack of factual specificity in pleading. As the grip tightens, there is room to wonder whether some judges' use of Rule 9(b) to throttle business fraud cases does not exhibit the sort of behavior once characterized by Justice Blackmun as "a preternatural solicitude for corporate well-being and a seeming callousness toward the investing public."¹⁹⁸

IV. PROVING SCIENTER IN FRAUD CASES AGAINST PROFESSIONALS

A. *Culpability Requirements Under Criminal Law*

1. *Intent Under the Model Penal Code*

Given the existing confusion over culpability standards in civil cases, criminal law precedent has potential to offer some guidance. One would assume that determining culpability standards applicable to professionals under statutory criminal laws ought to be easy. After all, legislatures are delegated the responsibility of defining the elements of criminal offenses, and federal crimes are "solely creatures of statute."¹⁹⁹ Nonetheless, the Supreme Court observed in *United States v. Bailey*²⁰⁰ that "the word 'intent' is quite ambiguous,"²⁰¹ and that "[f]ew areas of criminal law pose more difficulty than the proper defi-

197. 111 S. Ct. 2773 (1991).

198. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 762 (1975) (Blackmun, J., dissenting).

199. *Liparota v. United States*, 471 U.S. 419, 424 (1985). Of course, Congress is obliged to work within constitutional limits. *Id.* n.6.

200. 444 U.S. 394 (1980).

201. *Id.* at 408.

inition of the *mens rea* required for any particular crime.”²⁰² This confusion has been attributed to the simplistic tendency of the common law to classify the intent requirement of crimes as either “general intent” or “specific intent” with there being no uniform, consistent, or coherent usage of the terms.²⁰³ The criminal law’s ambiguity on the crucial issue of intent spawned an influential reform effort in the form of the Model Penal Code prepared under the auspices of the American Law Institute.

More than thirty-five years ago, the Model Penal Code’s drafters addressed the criminal law’s confusing approach to culpability issues in an effort

to advance the clarity of draftsmanship in the delineation of the definitions of specific crimes, to provide a distinct framework against which these definitions may be tested, and to dispel the obscurity with which the culpability requirement is often treated when such concepts as “general criminal intent,” “*mens rea*,” “presumed intent,” “malice,” “wilfulness,” “scienter,” and the like must be employed. What Justice Jackson called “the variety, disparity and confusion” of judicial definitions of “the requisite but elusive mental element in crime should as far as possible, be rationalized by a criminal code.”²⁰⁴

Accordingly, Model Penal Code section 2.02 “attempts the extremely difficult task of articulating the kinds of culpability that may be required for the establishment of liability.”²⁰⁵ Section 2.02(1) provides that “a person is not guilty of an offense unless he acted purposely, knowingly, recklessly or negligently, as the law may require, with respect to each material element of the offense.”²⁰⁶ The Model Code’s analytical demand that a level of culpability be assigned to each element of the offense found favor with the Supreme Court in *Bailey*, which characterized an element-by-element analysis as “a useful tool for making sense of an otherwise opaque concept.”²⁰⁷

202. *Id.* at 403.

203. *See id.* at 403 (citing W. LAFAVE & A. SCOTT, HANDBOOK ON CRIMINAL LAW § 28, at 201-02 (1972)).

204. MODEL PENAL CODE & COMMENTARIES § 2.02 comment 1, at 230 (1985).

205. *Id.* at 229.

206. MODEL PENAL CODE § 2.02(1) (1985). The hierarchy does not cover criminal offenses with no *mens rea* requirement. Those offenses are categorized as “violations.” *Id.* § 2.05(1).

207. *Bailey*, 444 U.S. at 407. The element-by-element approach was deemed subject to two qualifications. First, congressional intent concerning any level of culpability for an offense is to be followed. *Id.* Second, the Court vaguely warned courts or scholars working within the systematic approach not to “become obsessed with hair-splitting distinctions, either traditional or novel, that Congress neither stated nor implied when it made the conduct criminal.” *Id.* at 405-06.

Synonyms for “purposely,” sitting at the top level of culpability in the Model Penal Code’s descending hierarchy, are “intentionally,” “with intent,” “designed,” or “with design.”²⁰⁸ “Willfully,” which has been termed “a word of many meanings,”²⁰⁹ is equated with “knowingly,” not “purposely.”²¹⁰ “Purposely” generally correlates with the common law’s “specific intent.”²¹¹ Both “knowingly” and “recklessly” correspond, according to the Model Code’s drafters, with the “the common law requirement of ‘general intent.’”²¹² The general intent requirement at common law was not a rigorous one. Indeed, as Justice Brennan pointed out in *Smith v. Wade*,²¹³ at common law “crimes of intent commonly required only intent to do the criminal act (and, in some cases, knowledge that the injury would likely follow), rather than actual ill will or purpose to inflict an injury.”²¹⁴ The limited distinction between purpose and knowledge has not been viewed as significant, since “there is good reason for imposing liability whether the defendant desired or merely knew of the practical certainty of the result.”²¹⁵ Hence, whether a criminal defendant has acted “purposely” or “knowingly” usually makes little difference.

Under the Model Penal Code, the proper categorization of conduct within the four-part hierarchy depends on whether the element involves: (1) the nature of the person’s conduct, (2) results of the per-

208. MODEL PENAL CODE § 1.13(11)-(12) (1985).

209. *Spies v. United States*, 317 U.S. 492, 497 (1943). Judge Learned Hand participated in drafting the Model Penal Code. In the course of ALI proceedings in the Code’s development, this exchange occurred between the Reporter and Judge Hand:

JUDGE HAND: Do you use [willfully] throughout? How often do you use it? It’s a very dreadful word.

MR. WECHSLER: We will never use it in the Code

JUDGE HAND: It’s an awful word! It is one of the most troublesome words in a statute that I know. If I were to have the index purged, ‘wilful’ [sic] would lead all the rest in spite of its being at the end of the alphabet.

MR. WECHSLER: I agree with you Judge Hand, and I promise you unequivocally that the word will never be used in the definition of any offense in the Code.

MODEL PENAL CODE & COMMENTARIES § 2.02, comment 10, at 249 n.47 (1985).

210. *Id.* § 2.02(8). However, in *United States v. Murdock*, 290 U.S. 392, 394 (1933), the Court equated “willfully” as used in criminal statutes with “an act done with a bad purpose,” though it also recognized that the term is used often to denote “an act which is intentional, or knowing, or voluntary.”

211. MODEL PENAL CODE & COMMENTARIES § 2.02 comment, at 233-34 (1985) (citing ALI Proceedings 160 (1955)).

212. MODEL PENAL CODE § 2.02(3) explanatory note, at 23 (1985).

213. 461 U.S. 30 (1983).

214. *Id.* at 41.

215. *United States v. United Gypsum Co.*, 438 U.S. 422, 445 (1978). The Court noted that: “In either circumstance the defendants are consciously behaving in a way the law prohibits, and such conduct is a fitting object of criminal punishment.” *Id.*

son's conduct, or (3) the person's appreciation of the attendant circumstances.²¹⁶ The definitional differences between the Model Penal Code's first two categories²¹⁷ are slight,²¹⁸ as shown in the following chart:

Type of Material Element of Crime	"Purposely"	"Knowingly"
Nature of Conduct	Conscious object to engage in such conduct	Aware conduct is of that nature
Results of person's conduct	Conscious object to cause such result	Practically certain conduct will cause such a result
Appreciation of attendant circumstances	Aware or believe or hope circumstances exist	Aware circumstances exist

216. MODEL PENAL CODE § 2.02 (1985).

217. Section 2.02(2)(a) defines "purposely" in the following way:

A person acts purposely with respect to a material element of an offense when:

(i) if the element involves the nature of his conduct or a result thereof, it is his conscious object to engage in conduct of that nature or to cause such a result; and

(ii) if the element involves the attendant circumstances, he is aware of the existence of such circumstances or he believes or hopes that they exist.

Id. § 2.02(a)

"Knowingly" is defined in § 2.02(b):

A person acts knowingly with respect to a material element of an offense when:

(i) if the element involves the nature of his conduct or the attendant circumstances, he is aware that his conduct is of that nature or that such circumstances exist; and

(ii) if the element involves a result of his conduct, he is aware that it is practically certain that his conduct will cause such a result.

Id. § 2.02(b).

218. Comment 2 to § 2.02 recognizes that generally an inconsequential difference exists between an actor having a "conscious object to perform an action" and "acting knowingly." The need for differentiation is ascribed to statutes giving rise to "the awkward concept of 'specific intent.'" MODEL PENAL CODE & COMMENTARIES § 2.02 comment 2, at 233-34 (1985). Examples of specific intent crimes given by the drafters are treason, "in so far as a purpose to aid the enemy is an ingredient of the offense," and "attempts and conspiracy, where a true purpose to effect the criminal result is requisite for liability." *Id.* at 234. See also *United States v. Bailey*, 444 U.S. 394, 404 (1980) (noting that heightened culpability is relevant in "certain narrow classes of crimes," such as attempt, conspiracy, treason, and homicide).

In view of the major role recklessness plays in civil scienter formulations, it is interesting to note that, as recently as 1955, "recklessness" evidently was not defined by any statute.²¹⁹ The Model Penal Code's drafters defined "reckless misconduct" as follows:

A person acts recklessly with respect to a material element of an offense when he consciously disregards a substantial and unjustifiable risk that the material element exists or will result from his conduct. The risk must be of such a nature and degree that, considering the nature and purpose of the actor's conduct and the circumstances known to him, its disregard involves a gross deviation from the standard of conduct that a law-abiding person would observe in the actor's situation.²²⁰

The Model Code's criminal recklessness definition, which comfortably embraces the generally accepted 10b-5 recklessness definition quoted above,²²¹ substantially has been accepted as a model for the formulation of recklessness in many states' penal codes.²²²

"Purposely" and "knowingly" both connote premeditation and deliberate misconduct, with the chief difference being that the person acting purposely is seeking a certain result consciously, while the person acting knowingly is aware the result is "practically [but not entirely] certain."²²³ The "recklessly" definition expands on the concept of the actor as risk-of-injury creator. It addresses misconduct arising from conscious risk creation in the face of long odds for success and an unacceptable risk of serious injury in the event of failure. The misconduct envisioned by "recklessly" revolves around appreciation of a grave contingent risk of harm to others that the gambler consciously created and disregarded.²²⁴

Accountability based on probability analysis likewise is embraced by the Model Penal Code's knowledge definition, which reads: "When knowledge of the existence of a particular fact is an element of an offense, such knowledge is established if a person is aware of a high probability of its existence, unless he actually believes that it does not

219. MODEL PENAL CODE & COMMENTARIES § 2.02 comment 3, at 238 (1985).

220. MODEL PENAL CODE § 2.02(c) (1985).

221. See *supra* note 73 and accompanying text.

222. MODEL PENAL CODE & COMMENTARIES § 2.02 comment 3, at 238 (1985).

223. MODEL PENAL CODE § 2.02(b)(ii) (1985).

224. MODEL PENAL CODE & COMMENTARIES § 2.02 comment 3, at 236-37 (1985). Under the Model Penal Code, "negligently" generally follows the definition of "recklessly," with the chief difference being that a person is not required to "consciously disregard" the risk. It is enough that the person "should be aware of the substantial and unjustifiable risk," and that failure to perceive the risk involves a gross deviation from the standard of care that a reasonable person would observe. *Id.* § 2.02(d).

exist.”²²⁵

The Model Code’s explanation of “knowledge” is reminiscent of the *Derry v. Peek*²²⁶ court’s holding that a person with an honest but unreasonable belief in the truth of his statement cannot be liable for fraud. This formulation of knowledge in the criminal context was approved by the United States Supreme Court in *Leary v. United States*,²²⁷ and each of the federal circuit courts has either adopted the definition or borrowed heavily from it.²²⁸ It has been attacked for importing a recklessness standard into the concept of knowledge.²²⁹ The nub of the criticism is that recklessness and the Model Code’s knowledge definition both are built on apprehension of probability, while true knowledge requires certainty.²³⁰ The supposed requirement that knowledge rest on nothing short of absolute certainty has not stopped the Supreme Court from finding criminal intent based on a knowledge standard when action was undertaken in the face of a probable, but not certain, illegal result.²³¹ In any event, the Model Code’s knowledge definition has the virtue of protecting a defendant shown to have acted in subjective good faith.

225. MODEL PENAL CODE § 2.02(7) (1985).

226. 14 App. Cas. 337 (H.L. 1889). See *supra* notes 14-22 and accompanying text.

227. 395 U.S. 6, 46 n.93 (1968). The approval was reiterated in *Turner v. United States*, 396 U.S. 398, 416 n.29 (1970), and *United States v. Freed*, 401 U.S. 601, 614 n.5 (1971) (Brennan, J., concurring).

228. Robbins, *The Ostrich Instruction: Deliberate Ignorance as Criminal Mens Rea*, 81 J. CRIM. L. & CRIMINOLOGY 191, 194 n.11 (1990).

229. *Id.* at 191-205, 223-24, 231-32.

230. *Id.* at 222.

231. In *United States v. United States Gypsum Co.*, 438 U.S. 422 (1978), Mr. Justice Burger, writing for the majority, acknowledged the Model Penal Code’s four levels of intent, and eliminated the lower two as possibilities in criminal antitrust cases, saying: “In dealing with the kinds of business decisions upon which the antitrust laws focus, the concepts of recklessness and negligence have no place.” *Id.* at 444. The Court then settled on an intent requirement satisfied by proof of “action undertaken with knowledge of its probable consequences and having the requisite anticompetitive effects.” *Id.* The Court in *United States Gypsum* did not read a recklessness standard out of the criminal antitrust laws; instead, it actually applied the Model Penal Code’s recklessness formulation. Under the Model Code’s recklessness definition, culpability follows when the actor “consciously disregards a substantial and unjustifiable risk that the material element [anticompetitive effects] exists or will result from his conduct.” MODEL PENAL CODE § 2.02(2)(c) (1985). A risk “consciously disregarded” must be apprehended and known in the first place. Significantly, in *United States Gypsum*, the Court focused on the actor’s apprehension of the probable results (anticompetitive effects) of the actor’s conduct, not on the probable existence of a fact. The Model Code’s drafters made clear that one who disregards the high probability that a fact exists is charged with knowledge. Recklessness results “when what is involved is the result of the defendant’s conduct, necessarily a matter of the future at the time of acting.” *Id.* § 2.02 comment 9, at 130 (Tentative Draft No. 4 1955).

Under the Model Penal Code's hierarchy of culpability, proof that the defendant acted purposely meets a knowingly requirement, and proof that a person acted purposely and knowingly meets a recklessness culpability threshold.²³² It is important to note, however, that under Model Penal Code section 2.02(3), any criminal law element that does not have a culpability-level prescribed for it can be satisfied if the person acted purposely, knowingly, or recklessly.²³³ In other words, the drafters envisioned recklessness sufficing to establish criminal culpability absent evidence of a contrary legislative intent. They did this accepting "as the basic norm what usually is regarded as the common law position."²³⁴ The generally accepted common-law position views recklessness as a sufficient level of criminal intent; this casts doubt on the reasonableness of courts in 10b-5 cases demanding a higher level of scienter in civil suits against professionals.

2. "Conscious Avoidance" As Evidence of Intent

In criminal cases, a crucial task for prosecutors, defense counsel, and judges is determining the level of intent necessary to convict and then formulating instructions to guide the jury's deliberations. Here, descriptions of the borderlines between culpability formulations become key, with the debate assuming partisan aspects: the defense wants the prosecution to meet the highest possible standard of proof; the prosecution will seek an intent standard that is as easily satisfied as possible. Thus, advocates with a pro-defense bias will demand prosecutors meet a "purpose" or "knowledge" standard defined to have the highest possible culpability threshold. They may argue that the prosecution must fail absent proof beyond a reasonable doubt that the defendant had knowledge of a material element of the crime as a matter of cold-blooded, deliberate, absolute, subjective certainty. For example, those with a pro-defense outlook may contend that:

[c]riminal knowledge requires certainty and a corresponding absence of doubt. It is this distinction between certainty and probability that separates knowledge from the legal concept of recklessness: both involve awareness, but recklessness describes recognition of probability while knowledge requires certainty. Therefore, one "knows" something only if he or she is certain of it.²³⁵

232. MODEL PENAL CODE § 2.02(5) (1985).

233. When the culpability sufficient to establish a material element of an offense is not proscribed by law, this element is established if a person acts purposely, knowingly, or recklessly with respect thereto. *Id.* § 2.02(3).

234. *Id.* § 2.02(c) comment 5, at 244.

235. Robbins, *supra* note 228, at 222.

Prosecutors, on the other hand, know that criminal defendants who go to trial, at least those who are represented by able counsel, tend to be very uncooperative. The one thing criminal defendants are apt to admit is that they know for certain that they do not deserve to go to jail. To counteract a claimed lack of knowledge by criminal defendants, prosecutors are forced to rely on circumstantial evidence to show either that the defendant actually was aware of the element in question, or that the defendant must have been aware of the element because he consciously disregarded the substantial and unjustifiable risk the element either was present or would result from his conduct.²³⁶ This second form of behavior allows an inference of knowledge based on the jury's conclusion that the defendant must have been aware of his own conscious disregard of material risk. Whether deemed "conscious avoidance,"²³⁷ "deliberate disregard,"²³⁸ "willful blindness,"²³⁹ "deliberately closing [one's] eyes,"²⁴⁰ or having the "conscious purpose to avoid learning the truth,"²⁴¹ the basic concept is the same and is simply stated: A defendant who denies knowing may be proved to have had the requisite guilty knowledge based on accumulated circumstantial evidence. According to the Eighth Circuit, "[t]he willful blindness

236. See *United States v. Markopoulos*, 848 F.2d 1036, 1040 (10th Cir. 1988); *United States v. Alvarado*, 838 F.2d 311, 314 (9th Cir.), *cert. denied*, 487 U.S. 1222 (1988). Thus, in *United States v. Manriquez Arbizu*, 833 F.2d 244 (10th Cir. 1987), the trial court used a "deliberate ignorance" instruction to describe to the jury how deliberate ignorance may be circumstantial proof of scienter, and the appellate court affirmed, observing:

The purpose of such an instruction is to alert the jury to the fact that the act of avoidance of knowledge of particular facts may itself circumstantially show that the avoidance was motivated by sufficient guilty knowledge to satisfy the statute. The quoted instruction makes that clear. It informs the jury that it may look at the charade of ignorance as circumstantial proof of knowledge. It does not authorize conviction of one who in fact does not have guilty knowledge. One can in fact not know many detailed facts but still have enough knowledge to demonstrate consciousness of guilty conduct sufficient to satisfy the "knowing" element of the crime. In effect, the instruction is nothing more than a refined circumstantial evidence instruction properly tailored to the facts of a case like this.

Id. at 248.

237. *E.g.*, *United States v. Hanlon*, 548 F.2d 1096, 1101 (2d Cir. 1977).

238. *E.g.*, *United States v. Gentile*, 530 F.2d 461, 470 (2d Cir.), *cert. denied*, 426 U.S. 936 (1976).

239. *E.g.*, Edwards, *The Criminal Degrees of Knowledge*, 17 MODERN L. REV. 294, 301 (1954).

240. *United States v. Sarantos*, 455 F.2d 877, 881 (2d Cir. 1972). See also *United States v. Fingado*, 934 F.2d 1163, 1166 (10th Cir. 1991) ("The element of knowledge may be satisfied by inferences drawn from proof that a defendant deliberately closed his eyes to what would otherwise have been obvious to him.").

241. *United States v. Jacobs*, 475 F.2d 270, 287 n.37 (2d Cir.), *cert. denied*, 414 U.S. 821 (1973).

instruction . . . plays a role when knowledge is required, but as a mechanism for inference, not as a substitute for knowledge.”²⁴² Conscious avoidance or willful blindness is not knowledge, it is evidence of knowledge.

Knowledge may be inferred from circumstantial evidence,²⁴³ and it often must be, particularly when the facts are tangled, the transaction is complex, and the defendants are sophisticated, or at least clever. As the First Circuit noted in *United States v. Wells*:²⁴⁴ “Being a state of mind, willfulness can rarely be proved by direct evidence. Rather, findings of willfulness usually require that fact finders reasonably draw inferences from available facts.”²⁴⁵ Conduct properly characterized as

242. *Mattingly v. United States*, 924 F.2d 785, 791 (8th Cir. 1991). On the other hand, the Second Circuit in *United States v. Berkery*, 919 F.2d 817 (2d Cir. 1990), upheld an instruction charging: “[T]he element of knowledge of a given fact may be satisfied by proof beyond a reasonable doubt that a defendant acted with a conscious avoidance of what the truth was, unless he actually believed the contrary to be true.” *Id.* at 822. The *Berkery* charge corresponds to the explanation of knowledge found in MODEL PENAL CODE § 2.02(7) (1985) and accepted by the Supreme Court in *Leary and Turner*. See *supra* note 227 and accompanying text. In *United States v. Hiland*, 909 F.2d 1114 (8th Cir. 1990), the Eighth Circuit suggested that conscious avoidance can supply the knowledge element in a prosecution: “In essence, a willful blindness instruction ‘allows the jury to impute knowledge to [the defendant] of what should be obvious to him, if it found beyond a reasonable doubt, a conscious purpose to avoid enlightenment.’” *Id.* at 1130 (quoting *United States v. Zimmerman*, 832 F.2d 454, 458 (8th Cir. 1987)). The willful blindness instruction upheld in *Hiland*, as presented in the appellate opinion, reads:

The element of knowledge may be satisfied by inferences drawn from proof that a defendant deliberately closed his eyes, which [sic] would have otherwise been obvious to him. A finding beyond a reasonable doubt with [sic] a conscious purpose to avoid in light [sic] would permit an inference of knowledge.

Stated another way, a defendant’s knowledge of a fact may be inferred from willful blindness to the existing fact. It’s entirely up to you as to whether you find any deliberate closing of the eyes and inferences to be drawn from any such evidence.

The showing of negligence of a statement [sic] is not sufficient to support a finding of willfulness or knowledge.

Id. at 1129-30 n.22.

243. *United States v. Hooks*, 780 F.2d 1526, 1529 (10th Cir.) (circumstantial evidence, taken together with any reasonable inferences which flow from such evidence, is sufficient to establish guilt beyond a reasonable doubt), *cert. denied*, 475 U.S. 1128 (1986); *United States v. Cerro*, 775 F.2d 908, 911 (7th Cir. 1985).

244. 766 F.2d 12 (1st Cir. 1985).

245. *Id.* at 20. See also *Aiken v. United States*, 108 F.2d 182, 183 (4th Cir. 1939) (“Fraudulent intent, as a mental element of crime . . . is too often difficult to prove by direct and convincing evidence. In many cases it must be inferred from a series of seemingly isolated acts and instances which have been rather aptly designated as badges of fraud. When these are sufficiently numerous they may in their totality properly justify an inference of a fraudulent intent; and this is true even though each act or instance, standing by itself, may seem rather unimportant.”) *Griswold v. Gebbie*, 126 Pa. 353, 365,

reckless may not be exactly the same thing as knowing or intentional misconduct, but evidence of recklessness entitles the finder of fact to infer the requisite guilty knowledge or intent to defraud.²⁴⁶

Thus, criminal prosecutors increasingly are urging use of deliberate ignorance or “ostrich” instructions to convey to the jury that the defendant’s behavior in avoiding knowledge showed sufficient awareness to satisfy the knowledge, intent, or scienter requirement of a specific criminal statute.²⁴⁷ By attacking defendants for consciously avoid-

17 A. 673, 675 (1889) (“Fraud and intent to deceive do not proclaim themselves openly, nor can they usually be proved by direct evidence.”); Milich, *Securities Fraud Under Section 10(b) and Rule 10b-5: Scienter, Recklessness, and the Good Faith Defense*, 11 J. CORP. L. 179, 185 (1986).

246. See *United States v. Castro*, 887 F.2d 988, 994 (9th Cir. 1989) (in a case charging misapplication of bank funds under 18 U.S.C. § 656, “[i]ntent to defraud may be inferred from a defendant’s reckless disregard of the bank’s interests”); *United States v. Adamson*, 700 F.2d 953, 965 (5th Cir.), cert. denied, 464 U.S. 833 (1983) (reversing criminal convictions under 18 U.S.C. § 656 because of jury instructions that likened recklessness to intent to defraud, but also observing: “[T]he trier of fact may infer the required intent, i.e., knowledge, from the defendant’s reckless disregard of the interest of the bank; however, jury instructions should not equate recklessness with intent to injure or defraud.”).

247. In *United States v. Manriquez Arbizo*, 833 F.2d 244 (10th Cir. 1987), the court stated:

Arbizo alleges error in the court’s instruction to the jury on guilty knowledge. Count one of the indictment charged Arbizo with “knowingly and intentionally” possessing marijuana with intent to distribute. 21 U.S.C. § 841(a)(1). The district court gave the following instruction explaining how “deliberate ignorance” itself may be circumstantial proof of the existence of the necessary knowledge of illegal conduct:

The element of knowledge may be satisfied by inferences drawn from proof that a defendant deliberately closed his eyes to what would otherwise have been obvious to him.

A finding beyond a reasonable doubt of a conscious purpose to avoid enlightenment would permit an inference of knowledge.

Stated another way, a defendant’s knowledge of a fact may be inferred from willful blindness to the existence of the fact.

It is entirely up to you as to whether you find any deliberate closing of the eyes and the inference to be drawn from such evidence.

A showing of negligence or mistake is not sufficient to support a finding of willfulness or knowledge.

...

Arbizo argues the facts of his case were insufficient to warrant giving the instruction. He alleges the instruction allowed the jury to convict him on a negligence standard of knowledge—that he should have known his conduct was illegal—rather than the higher standard of actual knowledge required by the statute.

We have previously approved the giving of a similar instruction. The purpose of such an instruction is to alert the jury to the fact that the act of avoidance of knowledge of particular facts may itself circumstantially show that the

ing incriminating information, prosecutors in drug cases have been able to thwart drug pushers' efforts to escape accountability by keeping participants in their criminal enterprises uninformed of certain facts.²⁴⁸ A conscious avoidance jury charge allows the jury to pierce through the trappings of ignorance to the reality of complicity. The Tenth Circuit discerned in one recent drug case:

"[D]eliberate ignorance" refers to circumstantial evidence that the person against whom it is employed has actual knowledge of a fact in issue. . . . "A deliberate ignorance instruction alerts the jury 'that the act of avoidance of knowledge of particular facts may itself circumstantially show that the avoidance was motivated by sufficient guilty knowledge to satisfy the . . . "knowing" element of the crime.'"²⁴⁹

Facts that tend to prove actual knowledge and deliberate ignorance naturally will tend to overlap and intertwine, a reality deliberately ignored by the Tenth Circuit in its recent ruling that the same facts cannot be used to prove "both actual knowledge and deliberate ignorance,"²⁵⁰ on the theory that "the two are mutually exclusive concepts."²⁵¹ Of course, this is not true. Though knowledge and ignorance are antonyms, the prosecutor does not use proof of deliberate ignorance in a criminal case to prove an absence of knowledge, but just the opposite. Obviously, a jury has no business convicting a defendant found to have lacked knowledge of an element of the offense. But actual knowledge and deliberate ignorance can coexist very comfortably. After all, what the jury shows it has concluded when it convicts based on a deliberate ignorance instruction is that the defendant actually did have guilty knowledge.²⁵²

avoidance was motivated by sufficient guilty knowledge to satisfy the statute. The quoted instruction makes that clear. It informs the jury that it may look at the charade of ignorance as circumstantial proof of knowledge. It does not authorize conviction of one who in fact does not have guilty knowledge. One can in fact not know many detailed facts but still have enough knowledge to demonstrate consciousness of guilty conduct sufficient to satisfy the "knowing" element of the crime. In effect, the instruction is nothing more than a refined circumstantial evidence instruction properly tailored to the facts of a case like this.

Id. at 248 (citations omitted).

248. *E.g., id.* at 249 ("Because the evidence was sufficient for a jury to find beyond a reasonable doubt Arbizo either directly knew or circumstantially knew by deliberately avoiding acquiring knowledge of the contents of the bags, the instruction was appropriate.").

249. *United States v. De Francisco-Lopez*, 939 F.2d 1405, 1409 (10th Cir. 1991).

250. *Id.* at 1410.

251. *Id.*

252. As the Tenth Circuit stated in *De Francisco-Lopez*: "The evidence must establish that the defendant had subjective knowledge of his criminal behavior." 939 F.2d at

When evidence of both direct knowledge and conscious avoidance exists, it is reasonable for a court to instruct that the knowledge element of an offense may be established by proof of either conscious avoidance or positive knowledge.²⁵³ A deliberate ignorance instruction is proper if there is evidence of suspicious circumstances, but not if the evidence only supports a conclusion of positive knowledge.²⁵⁴ A defendant who steadfastly protests good faith ignorance in the face of a mountain of incriminating evidence that is unequivocal and readily seen is fair game for both types of charges.²⁵⁵ To determine whether the defendant acted honestly, the jury is entitled to look through a defendant's protestations of lack of knowledge, negligence, or mistake.²⁵⁶ Conversely, it is improper to use a willful avoidance instruction when no facts point to conduct that translates into conscious avoidance of the truth.²⁵⁷ Otherwise, the charge could yield a conviction based on mere negligence.²⁵⁸

1409. This is just what a "willful ignorance" instruction is targeted at showing—not subjective ignorance, in which case the defendant goes free, but subjective knowledge.

253. *United States v. Jewell*, 532 F.2d 697, 700 (9th Cir.), *cert. denied*, 426 U.S. 951 (1976). *See also* G. WILLIAMS, CRIMINAL LAW: THE GENERAL PART § 57, at 159 (2d ed. 1961) ("The rule that willful [sic] blindness is equivalent to knowledge is essential, and is found throughout the criminal law.").

254. *See, e.g., United States v. Sanchez-Robles*, 927 F.2d 1070, 1074 (9th Cir. 1991).

255. *See United States v. Victor Teicher & Co.*, 1990 WL 37842 (S.D.N.Y. Mar. 27, 1990) (WESTLAW), in which the court observed: "Typically the government requests and obtains a conscious avoidance charge when a defendant's conduct, while arguably furnishing direct evidence of his guilty knowledge, may in the alternative be regarded as reflecting conscious avoidance of knowledge." *Id.* A conscious avoidance instruction may be refused, however, when the government's theory from the outset is based on actual knowledge, and it seeks to include an alternative conscious avoidance late in the game. *Id.*

256. *See United States v. Cheek*, 111 S. Ct. 604, 611-12 (1991) (pointing out the jury's right to find the government has proved knowledge by rejecting the defendant's cover story). Thus, in *United States v. Farfan-Carreón*, 935 F.2d 678 (5th Cir. 1991), a conscious avoidance charge was used to convict in the face of the defendant's story that he had asked and had been assured the truck he drove did not carry contraband. In *United States v. Fingado*, 934 F.2d 1163 (10th Cir. 1991), a tax prosecution, the defendant was charged with willful failure to file. He contended he had a good faith belief in the accuracy of his understanding of the tax laws, but he avoided verifying his views by consulting with an accountant or an attorney, choosing instead to consult with other, like-minded citizens who agreed there was no obligation to file returns. The jury was instructed not to convict based on negligence, mistake, and not to convict if it determined Fingado acted in good faith or honestly misunderstood the tax law.

257. *See, e.g., United States v. Manriquez Arbizó*, 833 F.2d 244, 249 (10th Cir. 1987); *United States v. Murrieta-Bejarano*, 552 F.2d 1323, 1323 (9th Cir. 1977).

258. *See, e.g., United States v. Bright*, 517 F.2d 584, 587 (2d Cir. 1975) ("A negligent or a foolish person is not a criminal when criminal intent is an ingredient.").

3. *Application of Conscious Avoidance Theory to Professionals Involved in Business Transactions*

Willful avoidance instructions have been used most conspicuously in drug prosecutions, but drug racketeers are not the only criminals who make attractive targets for willful avoidance instructions; so do participants in fraudulent business ventures. A well-known criminal securities case involving both a lawyer and an accountant is *United States v. Benjamin*.²⁵⁹ The opinion, written by Judge Friendly, is known for its *dicta*, premised in part on the Model Penal Code. It suggests that lawyers and accountants can engage in criminal securities violations by engaging in willful avoidance equivalent to recklessness.²⁶⁰

More recently, in *United States v. Glick*,²⁶¹ a CPA who blatantly violated accounting principles and auditing standards was convicted in a case in which the jury was charged as follows on the definition of "knowingly": "An act is done knowingly if done voluntarily and intentionally and not because of mistake or accident or other innocent reason. The purpose of adding the word 'knowingly' is to ensure that no one would be convicted for an act done because of mistake or accident or innocent reason."²⁶² The lower court then described the relationship between intent and deliberate ignorance:

In order to convict the defendant in this case, you must find that he acted knowingly.

It is not necessary, however, for the Government to prove that the defendant was aware of every detail of the alleged scheme to defraud, so long as you find beyond a reasonable doubt that he was a knowing

259. 328 F.2d 854 (2d Cir.), *cert. denied*, 377 U.S. 953 (1964).

260. The court stated:

[I]n the context of § 24 of the Securities Act as applied to § 17(a), the Government can meet its burden by proving that a defendant deliberately closed his eyes to facts he had a duty to see, . . . Model Penal Code § 2.02(7) commentary in Tentative Draft No. 4, at 129-30 (1955) In our complex society the accountant's certificate and the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar. Of course, Congress did not mean that any mistake of law or misstatement of fact should subject an attorney or an accountant to criminal liability simply because more skillful practitioners would not have made them. But Congress equally could not have intended that men holding themselves out as members of these ancient professions should be able to escape criminal liability on a plea of ignorance when they have shut their eyes to what was plainly to be seen or have represented a knowledge they knew they did not possess.

Id. at 862-63.

261. 710 F.2d 639 (10th Cir. 1983), *cert. denied*, 465 U.S. 1005 (1984).

262. *Id.* at 643 n.4.

participant in the scheme.

It is not sufficient for you to find beyond a reasonable doubt that Mr. Glick knew the financial statements were used to guarantee loans, since such transactions are legal. For you to convict Mr. Glick, you must find beyond a reasonable doubt that he was aware of the fraudulent aspects of the transactions.

However, the element of knowledge may be established by proof that a defendant deliberately closed his eyes to what otherwise would have been obvious to him. In other words, the requirement that the defendant has acted knowingly does not mean that the defendant needed to have positive knowledge. If the defendant failed to have positive knowledge only because he conscientiously avoided acquiring it, the requirement of knowledge is satisfied

It is not sufficient to merely prove that Steven Glick prepared fraudulent financial statements. The prosecution must also prove beyond a reasonable doubt that Mr. Glick knowingly participated in the scheme or artifice involved in this case. Thus, if you find that Mr. Glick prepared fraudulent financial statements but did not intentionally and knowingly participate in the scheme or artifice involved in this case, you must find him not guilty.²⁶³

On appeal, the Tenth Circuit upheld the instruction, though it observed it would have preferred the trial court add the following language from the leading conscious avoidance case of *United States v. Jewell*:²⁶⁴ “(1) that the required knowledge is established if the accused is aware of a high probability of the existence of the fact in question, (2) unless he actually believes it does not exist.”²⁶⁵

Likewise, in two other cases where CPAs were prosecuted, *United States v. Weiner*²⁶⁶ and *United State v. Natelli*,²⁶⁷ judges approved instructions that allowed the juries to infer willful and knowing crimi-

263. *Id.*

264. 532 F.2d 697, 704 n.21 (9th Cir.) (en banc), cert. denied, 426 U.S. 951 (1976).

265. *Glick*, 710 F.2d at 643. The quoted language from *Jewell* is taken directly from the Model Penal Code's articulation in § 2.02(7) of the type of conduct that satisfies a knowledge requirement as to the “existence of a particular fact.” Inclusion of the language in a deliberate ignorance jury charge appears mandatory in the Second, Ninth, and Tenth Circuits. See *United States v. Feroz*, 848 F.2d 359, 361 (2d Cir. 1988) (“By now our message should be clear: the prosecutor should request that the ‘high probability’ and ‘actual belief’ language be incorporated into every conscious avoidance charge”); *United States v. Manriquez Arbizu*, 833 F.2d 244, 249 (10th Cir. 1987) (calling inclusion of the language “preferable” in order “[t]o insure that a defendant is only convicted if his ignorance is willful, rather than negligent”); *Jewell*, 532 F.2d at 704 n.21. The language is not mandatory in the Eighth or Fifth Circuits. See *United States v. Hiland*, 909 F.2d 1114, 1130 (8th Cir. 1990); *United States v. Deveau*, 734 F.2d 1023, 1028 (5th Cir. 1984), cert. denied, 469 U.S. 1158 (1985).

266. 578 F.2d 757 (9th Cir.), cert. denied, 439 U.S. 981 (1978).

267. 527 F.2d 311 (2d Cir. 1975), cert. denied, 425 U.S. 934 (1976).

nal securities violations based on the defendant auditors' "reckless deliberate indifference to or disregard for truth or falsity."²⁶⁸ In both cases, the reviewing courts called attention to the investigatory or truth-finding role played by the accountants by virtue of their position as auditors.²⁶⁹ Given their special public responsibility, the defendants' inaction in the face of the suspect facts before them supported an inference of knowing complicity.

Lawyers faced with the prospect of furthering clients' questionable transactions should study *United States v. Kehm*²⁷⁰ and *United States v. Sarantos*.²⁷¹ Both cases involved criminal convictions of lawyers caught up in their clients' criminal activities, and in both cases deliberate avoidance instructions were used to convict. In *Kehm*, Greenberg, a lawyer, was convicted based on an ostrich instruction where the facts showed that he had organized the company used to facilitate the transportation of drugs by airplane, that he knew the company's directors used pseudonyms, and that when the use of the plane came up at a meeting, Greenberg left, "with the remark that he didn't want to hear about it."²⁷² In *Sarantos*, the lawyer was convicted for having violated the federal false statement statute²⁷³ and for having aided and abetted false statements and violations of the immigration laws by processing paperwork relating to sham marriages. The jury charge explained that Sarantos could be found to have violated the false statement statute if "he knew . . . [the statements] were false and that he wilfully and knowingly participated in furthering the conduct."²⁷⁴ The charge defined "knowingly and wilfully as meaning that 'one knows what he or she is doing, as distinguished from an inadvertent or careless act'"²⁷⁵ and directed that the jury could conclude Sarantos "acted with reckless disregard of whether the statements made were true or with a conscious effort to avoid learning the truth . . . even though you may find that he was not specifically aware of the facts which would establish the falsity of the statements."²⁷⁶

Sarantos objected to the instruction on the ground that its appli-

268. *Weiner*, 578 F.2d at 786, 787; *Natelli*, 527 F.2d at 322-23.

269. *See Weiner*, 578 F.2d at 787; *Natelli*, 527 F.2d at 323.

270. 799 F.2d 354 (7th Cir. 1986).

271. 455 F.2d 877 (2d Cir. 1972).

272. *Kehm*, 799 F.2d at 362.

273. 18 U.S.C. § 1001 (1988).

274. *Sarantos*, 455 F.2d at 880.

275. *Id.*

276. *Id.* The appellate court conceded, in the face of Sarantos' objection that "and" would have been a better word than "or," but found any error caused by confusion to be harmless since "[t]he phrases 'reckless disregard of whether the statements made were true' and 'conscious purpose to avoid learning the truth' mean essentially the same thing." *Id.* at 882. The court "urged" the use of "and" in future charges. *Id.*

cation to him, a lawyer, would “radically alter the attorney-client relationship and make the attorney ‘an investigative arm of the government.’”²⁷⁷ The Second Circuit rejected the argument, finding that the purpose of a deliberate avoidance instruction is to close a potential loophole and thereby “prevent an individual like Sarantos from circumventing criminal sanctions merely by deliberately closing his eyes to the obvious risk that he is engaging in unlawful conduct.”²⁷⁸ The Second Circuit drew support from *Leary v. United States*²⁷⁹ and Model Penal Code section 2.02(7) for its view that deliberate avoidance permits an inference of knowledge.²⁸⁰ The distinctly liberal, pro-prosecution slant of the intent instructions approved by the Second Circuit in *Sarantos* is at odds with the same circuit’s pronounced reluctance to find scienter on the part of professionals in civil, white collar fraud cases.

Another business-related willful avoidance case is *United States v. Caliendo*,²⁸¹ a criminal RICO case involving a prostitution enterprise. One of the defendants was Susan Barker, a former prostitute and the enterprise owner’s “live-in girlfriend.”²⁸² Barker denied “knowingly violating a federal law,” despite proof that “she handled the records and receipts of an illicit business connected to the conspiratorial enterprise and managed an adult bookstore whose operation was closely affiliated with (if not subsumed by) an integral conspiratorial establishment”²⁸³

Barker’s denial of knowledge was answered with the following ostrich instruction which led to conviction: “You may infer knowledge from a combination of suspicion and indifference to the truth. If you find that a person had a strong suspicion that things were not what they seemed or that someone had withheld some important facts, yet

277. *Id.* at 880.

278. *Id.*

279. 395 U.S. 6 (1969).

280. *Sarantos*, 455 F.2d at 881. The court also reiterated its earlier approval of the Model Penal Code definition of “knowledge” in *United States v. Squires*, 440 F.2d 859, 863 (2d Cir. 1971): “This formulation (Model Penal Code 2.07(7)) is merely a more comprehensive version of the lay definition of ‘knowledge’ in that it recognizes that there are many facts which one does not ‘know with certainty,’ and it comports with the use of ‘knowingly’ in other criminal statutes.” *Id.* at 884.

281. 910 F.2d 429 (7th Cir. 1990).

282. *Id.* at 433.

283. *Id.* at 434. The bookstore was adjacent to a spa which served as a house of prostitution. The evidence showed that Barker had discussed a plan to have female spa employees, i.e., prostitutes, serve as “movie critics” for bookstore customers who watched movies in the bookstore’s booths. *Id.* Such circumstantial evidence of knowledge, coupled with Barker’s denial of knowledge of impropriety, validated the prosecution’s use of an ostrich instruction to permit the jury to find culpable intent. *Id.*

shut his or her eyes for fear of what he or she would learn, you may conclude that he or she acted knowingly, as I have used that word.”²⁸⁴ In affirming, the Seventh Circuit noted that limits exist to such an instruction’s application: The ostrich instruction is not, however, an all-purpose instruction appropriate under any circumstance. The instruction is “properly given only when the defendant claims a lack of guilty knowledge and there are facts and evidence that support an inference of deliberate ignorance.”²⁸⁵

Plainly, deliberate avoidance theory ideally is suited for large-scale, enterprise-related misconduct facilitated by professionals. The Seventh Circuit explained in *United States v. Diaz*,²⁸⁶

The ostrich instruction has been principally employed where there is evidence that the defendant is associated with a group, but where there is also evidence that the defendant consciously was avoiding knowledge of the illegal nature of the group’s activity. In most cases, the defendant acknowledges his association with the group but, despite circumstantial evidence to the contrary, denies knowledge of the group’s illegal activity.²⁸⁷

Although professionals do not usually supply the prosecution with direct evidence showing their cold-blooded, deliberate, premeditated intent to violate criminal law, such direct evidence of knowledge or intent rarely will be necessary to convict if an inference of knowledge or intent can be derived from conscious avoidance of the truth. Indeed, in one prosecution under the Mail Fraud Statute,²⁸⁸ a crime requiring proof of scienter or “intent to defraud”²⁸⁹ beyond a reasonable doubt, the First Circuit equated proof of scienter with conscious avoidance.²⁹⁰

284. *Id.* at 433.

285. *Id.* (citation omitted).

286. 864 F.2d 544, 550 (7th Cir. 1988), *cert. denied*, 490 U.S. 1070 (1989).

287. As examples, see *United States v. Bank of New England*, 821 F.2d 844, 855 (1st Cir.) (approving an instruction permitting an inference of knowledge “if a defendant consciously avoided learning about the reporting requirements” in the prosecution of a bank under the Currency Transaction Reporting Act), *cert. denied*, 484 U.S. 943 (1987); *United States v. Ramsey*, 785 F.2d 184 (7th Cir.) (employees of fraudulent loan brokerage operation claimed they were gullible and ignorant of criminal activities), *cert. denied*, 476 U.S. 1186 (1986); *United States v. Schwartz*, 787 F.2d 257 (7th Cir. 1986) (defendants claimed they had been duped in an auto insurance fraud scheme in which they had played roles; the jury was entitled to be told that a person who smells a rat and then avoids actual knowledge may already know enough for the purpose of the law); *United States v. Josefik*, 753 F.2d 585 (7th Cir.) (involvement in transfer of stolen scotch), *cert. denied*, 471 U.S. 1055 (1985).

288. 18 U.S.C. § 1341 (1988).

289. *United States v. Martin-Trigona*, 684 F.2d 485, 492 (7th Cir. 1982).

290. *United States v. Brien*, 617 F.2d 299, 312 (1st Cir.), *cert. denied*, 446 U.S. 919 (1980).

Likewise, in *United States v. Josefik*,²⁹¹ a conscious avoidance instruction was used to define intent to deceive. *Josefik* involved a prosecution for receiving stolen property.²⁹² The jury instruction used to convict was upheld on appeal; it explained that “[n]o person can intentionally avoid knowledge by closing his eyes to facts which should prompt him to investigate.”²⁹³

United States Supreme Court precedent teaches that “[c]riminal liability is normally based upon the concurrence of two factors, ‘an evil-meaning mind [and] an evil-doing hand.’”²⁹⁴ A review of recent criminal cases shows that juries are entitled to ascertain what was in defendants’ minds or caused defendants’ hands to move by studying the defendants’ eyes. If those eyes were deliberately averted from clues showing participation in crime that was plain to see, a jury is entitled to infer the presence of guilty knowledge sufficient to convict.

B. Evidentiary Factors to Determine *Scienter* in Civil Cases

In fraud cases against professionals, direct evidence of intent usually is lacking. As a result, the *scienter* issue normally must be resolved by inferences drawn from the “nature and purpose of the actor’s conduct and the circumstances known”²⁹⁵ to the actor. General definitions of *scienter* surely are useful, but specific facts should be weighed in individual cases. In evaluating factors relevant to a *plaintiff’s* recklessness, one 10b-5 case has cautioned that “[n]o single factor is determinative; all relevant factors must be considered and balanced.”²⁹⁶

If an array of factors deserves scrutiny in evaluating the behavior of a securities fraud victim, it is not extreme to suggest that the same ought to be true for the perpetrator. Indeed, the Ninth Circuit held as much when it promulgated its list of factors used to determine culpability under the now discarded “flexible duty” standard.²⁹⁷ An exami-

291. 753 F.2d 585 (7th Cir.), *cert. denied*, 471 U.S. 1055 (1985).

292. This involved an alleged violation of 18 U.S.C. § 569 (1976).

293. *Josefik*, 753 F.2d at 589.

294. *United States v. Bailey*, 444 U.S. 394, 402 (1980) (quoting *Morissette v. United States*, 342 U.S. 246, 251 (1952)).

295. MODEL PENAL CODE § 2.02(2)(c) (1985).

296. *Zobrist v. Coal-X, Inc.*, 708 F.2d 1511, 1516-17 (10th Cir. 1983).

297. The Ninth Circuit’s “flexible duty” test required courts to consider the following factors:

(1) the relationship of defendant to plaintiff; (2) defendant’s access to the information as compared to that of plaintiff; (3) defendant’s benefit derived from the relationship; (4) defendant’s awareness of whether plaintiff was relying on their relationship in making his or her investment decisions; and (5) defendant’s activity in initiating the transaction in question.

Zweig v. Hearst Corp., 594 F.2d 1261, 1268 (9th Cir. 1979) (paraphrasing *White v.*

nation of the defendant's culpability always will need to be shaped to the particular actor's individual circumstances. However, various generic avenues of inquiry concerning the actor's behavior need to be explored by courts and counsel in every case when scienter is or may be alleged. An analysis of cases against professionals shows that the following factors provided significant evidentiary indicia of scienter: (1) motive, including the professional's financial interest in the transaction; (2) sophistication of the fraud victims; (3) substantial participation by the professional in effectuating the transaction; (4) the professional's close relationship with other wrongdoers; (5) any unusual aspects of the transaction; and (6) evidence of the professional's "conscious avoidance" of facts proving participation in fraud.

1. *Motive, Including the Professional's Financial Interest in the Transaction*

An important, though not dispositive, factor in a scienter case relates to motive to defraud. Financial gain realized or to be realized through the scheme may be seen as evidence that the professional joined hands with other wrongdoers. As the Seventh Circuit said in *Barker v. Henderson, Franklin, Starnes & Holt*:²⁹⁸ "If the plaintiff does not have direct evidence of scienter, the court should ask whether the fraud (or cover-up) was in the interest of the defendants. Did they gain by bilking the buyers of the securities?"²⁹⁹ Financial inducements giving counsel a slice of the venture akin to a sales commission can provide a motive to defraud.³⁰⁰ The professional's financial incentive should be viewed, however, only as a factor, and not as an essential requirement for liability.³⁰¹

Abrams, 495 F.2d 724, 735-36 (9th Cir. 1974)).

298. 797 F.2d 490, 497 (7th Cir. 1986).

299. *Griffin v. McNiff*, 744 F. Supp. 1237 (S.D.N.Y. 1990) (evidence of scienter in the form of profit incentive on the part of two different law firms); *Boltz v. Flagship Partners Ltd. Partnership*, 1990 WL 125411 (N.D. Ill. Aug. 22, 1990) (WESTLAW) (defendant's conflict of interest viewed as suggesting he may have had an incentive to mislead one of the parties reposing trust in him).

300. See *In re Federal Bank & Trust Co.*, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,565 (D. Ore. 1984) (upholding RICO claim against opining lawyers who received an undisclosed contingent fee of one-half percent of the money raised from investors).

301. In *Barker* the Seventh Circuit suggested that an allegation of scienter made against an attorney could be rebutted when "it is inconceivable that [the lawyers] joined a venture to feather their nests by defrauding investors." 797 F.2d at 497. See also *Schlifke v. Seafirst Corp.*, 866 F.2d 935, 948 n.14 (7th Cir. 1989) (unsupported allegations of bank's economic stake in oil and gas limited partnership not sufficient to infer scienter). The court in *Mercer v. Jaffe, Snider, Raitt & Heuer, P.C.*, 736 F. Supp. 764 (W.D.

Another means of showing motive is to present facts revealing the professional's desire to keep from disclosing past or ongoing misconduct.³⁰² It should be noted that under Federal Rule of Evidence 404(b), evidence of a professional's other wrongs or acts may be admissible to prove motive, plan, intent, knowledge, or absence of mistake.³⁰³ Thus, evidence that a lawyer had in the past prepared fake invoices in connection with a scheme to defraud may be relevant to show that the attorney aided and abetted mail fraud rather than being duped by his clients.³⁰⁴

2. *The Fraud Victim's Sophistication*

As noted above, the Second Circuit has gone so far as to change the required culpability standard upward solely based on the nonexistence of a fiduciary relationship between the parties in an aider and abettor case.³⁰⁵ The Seventh Circuit's demand that aiders and abettors in 10b-5 cases be proved to have violated "positive law" requiring them

Mich. 1990), followed *Barker's* strict emphasis on motive based on monetary gain in refusing to find scienter on the part of the defendant lawyer:

[T]he record contains nothing upon which the jury could reasonably conclude that Karpen stood to gain by "bilking" the *Mercer* plaintiffs. See *Barker*, 797 F.2d at 497. Karpen was not being paid by the Diamond entities. *Id.* He in fact had "everything to lose" by "join[ing] common cause" with the Diamond entities, including his professional reputation and perhaps even his personal liberty. *Id.* Under these circumstances, "it is inconceivable that [Karpen] joined a venture to feather [his nest] by defrauding" investors in the Diamond and CMI securities.

Id. at 773. Far less sympathetic was the district court in *Blakely v. Lisac*, 357 F. Supp. 255, 263 (D. Ore. 1972), which held that the absence of profit was irrelevant and imposed 10b-5 liability on a nonlawyer finder whose name, status as a financial advisor, and \$2,500 fee were mentioned in a misleading prospectus, the accuracy of which the finder had taken no steps to investigate. It should be noted that proof of a financial incentive for a professional to engage in fraud has never been required in criminal prosecutions. See *United States v. Natelli*, 527 F.2d 311, 319 (2d Cir. 1975), *cert. denied*, 425 U.S. 934 (1976); *United States v. Simon*, 425 F.2d 796, 809 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970).

302. *Natelli*, 527 F.2d at 319.

303. FED. R. EVID. 404(b) provides: "Evidence of other crimes, wrongs, or acts is not admissible to prove the character of the person in order to show action in conformity therewith. It may, however, be admissible for other purposes, such as proof of motive . . . intent . . . knowledge . . . or absence of mistake or accident."

304. See *United States v. Gonzalez-Sanchez*, 825 F.2d 572 (1st Cir.), *cert. denied*, 484 U.S. 989 (1987).

305. *ROSS v. Bolton*, 904 F.2d 819 (2nd Cir. 1990); see *supra* note 79 and accompanying text. In *Schatz v. Rosenberg*, 943 F.2d 485 (4th Cir. 1991) the Fourth Circuit embraced the fiduciary duty view and expanded it to include confidential relationships.

to disclose the truth³⁰⁶ is but a reformulation of the Second Circuit's invention. The Fifth Circuit adopted a similar approach in *Abell v. Potomac Insurance Co.*, protecting a reckless firm that operated out of view.³⁰⁷ Each of these circuits appears to have adjusted the scienter formulation based on the single factor of the parties' relationship. However, if in judging culpability of behavior, "[n]o single factor is determinative, [and] all relevant factors must be considered and balanced,"³⁰⁸ then it is wrong to turn the relationship of the parties into a litmus test for culpability.

This is not to say, however, that the relationship between professionals involved in the transaction and investors is irrelevant. The relative sophistication of the parties to the transaction is and should receive careful scrutiny when there is a need to determine intent. The actor's sophistication and expertise naturally will tend to cut against professionals caught up in fraudulent schemes, particularly those who are performing as specialists. When the scheme involves unsophisticated members of the public, an inference of fraudulent intent is more likely to be warranted. The First Circuit pointed out in *United States v. MacDonald & Watson Waste Oil Co.*³⁰⁹ that an inference of fraudulent intent "is more particularly allowable when the actors or utterers are persons 'in a far better position to judge than the unsophisticated public to whom they sold.'"³¹⁰

3. *Substantial Participation by the Professional in Effectuating the Transaction*

Professionals who are involved intimately in fraudulent transactions should expect their performance to be scrutinized closely. The Model Penal Code's emphasis in its "recklessness" definition on the nature and purpose of the actor's conduct suggests that the extent of the actor's involvement in the transaction is an important factor in determining intent.

Whether the professional rendered an opinion or prepared documents crucial to the effectuation of the transaction is a particularly important factor in the analysis of intent,³¹¹ especially when the mater-

306. *DiLeo v. Ernst & Young*, 901 F.2d 624, 628 (7th Cir.), *cert. denied*, 111 S. Ct. 347 (1990). See *supra* notes 80-82 and accompanying text.

307. See *supra* notes 83-90 and accompanying text.

308. *Zobrist v. Coal-X, Inc.*, 708 F.2d 1511, 1516-17 (10th Cir. 1983).

309. 933 F.2d 35 (1st Cir. 1990).

310. *Id.* at 54 n.19 (quoting *United States v. Avant*, 275 F.2d 650, 653 (D.C. Cir. 1960)).

311. In *Wassel v. Eglowsky*, 399 F. Supp. 1330 (D. Md. 1975), *aff'd*, 542 F.2d 1235 (4th Cir. 1976), a contribution claim based on joint tortfeasor theory was allowed against

ials flow directly to the public.³¹² As one court observed, fraud liability may await “one who permits another to use his reputation and good will to further a fraudulent scheme.”³¹³ In these cases the professional is in the best position to assure that honest communications are made and is most likely to be aware that injury can result if the truth is not brought out. The professional who, acting as gatekeeper, controls access to needed information and determines what is said and not said, accepts great responsibility and, with it, great risk.³¹⁴ The Second Circuit emphasized in a criminal prosecution against CPAs:

[I]t simply cannot be true that an accountant is under no duty to disclose what he knows when he has reason to believe that, to a material extent, a corporation is being operated not to carry out its business in the interest of all the stockholders but for the private benefit of its president. . . . If certification does not at least imply that the corporation has not been looted by insiders so far as the accountants know . . . it would mean nothing, and the reliance placed on it by the public would be a snare and a delusion.³¹⁵

Commenting on the role of attorneys in papering deals and in rendering opinions, an SEC Commissioner once observed: “Lawyers are not

corporate counsel whose opinion letter improperly freed stock for transfer. The lawyer’s opinion was no more essential to the transaction than usual, but the court honed in on evidence of the attorney’s questionable conduct and found that his opinion was a proximate cause of the transaction. *See id.* at 1369-70. SEC v. Rogers, 790 F.2d 1450 (9th Cir. 1986) shows that a legal opinion can play a crucial role in the deal. In *Rogers* a divided circuit court affirmed the dismissal of SEC charges against a tax shelter salesman. In dissent, Judge Noonan complained that the lower court should be reversed, in part because the defendant had supplied facts upon which the tax opinion for the deal was based. According to Judge Noonan, “The tax opinion was vital. Without it, there would have been no sale.” *Id.* at 1462 (Noonan, J., dissenting).

312. The district court in *In re North Am. Acceptance Corp. Sec. Cases*, 513 F. Supp. 608, 626 (N.D. Ga. 1981), a 10b-5 aider and abettor case against a law firm that passed on advertisements and gave an opinion on the need to distribute offering material to investors, specifically noted the firm’s close proximity to the public in deciding to use a less rigorous scienter standard than would have applied had the firm’s contact been more remote from the public. The court was correct in viewing the professional’s key role as a factor to be weighed in analyzing the professional’s culpability. The court’s error was to presume that the scienter standard changes depending on the professional’s proximity to investors.

313. *Blakely v. Lisac*, 357 F. Supp. 255, 263 (D. Ore. 1972). *See also Rudolph v. Arthur Andersen & Co.*, 800 F.2d 1040 (11th Cir. 1986), *cert. denied*, 480 U.S. 946 (1987).

314. *Eisenberg v. Gagnon*, 766 F.2d 770, 776 (3d Cir.) (reversing judgment for defendant lawyer-opiner in tax shelter case; “those with greater access to information or having a special relationship to investors making use of the information” have an obligation to disclose data indicating that the opinion or forecast may be doubtful), *cert. denied*, 474 U.S. 134 (1985).

315. *United States v. Simon*, 425 F.2d 796, 806 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970).

paid in the amounts they are to put the representations of their clients into good English, or to give opinions which assert a pure state of facts upon which any third-year law student could confidently express an opinion.”³¹⁶

4. *The Professional's Close Relationship with Wrongdoers*

Professionals who wear the additional hat of an insider-executive in the transaction should expect more rigorous scrutiny than if they had worked purely as professionals on the periphery.³¹⁷

In *Shumate v. McNiff*³¹⁸ the court upheld 10b-5 allegations by investors asserted against the Ruffa & Hanover law firm which had been involved intimately in the securities offering and had rendered tax opinions. The court made clear the danger that awaits lawyers who become involved personally in their clients' business activities:

Defendants argue that plaintiffs have failed to meet the requirement for pleading scienter under Rule 9(b), because they allege only that Ruffa, Hanover and R & H “knew or should have known” of the various alleged misstatements. In addition, defendants assert, unless facts are alleged which indicate otherwise, a lawyer is presumed to act in good faith on information provided by his or her client. *See* SEC v. Frank, 388 F.2d 486, 489 (2d Cir. 1968).

The Court finds, however, that plaintiffs have pleaded sufficient facts to give rise to an inference of knowledge on the part of defendants Ruffa, Hanover and R & H. Plaintiffs have alleged that Ruffa, together with McNiff, owned an option to purchase 66.66% of the stock of the parent corporation. Ruffa is presumed, then, to have had knowledge of the actual operations of the Lps and the fraudulent scheme alleged by plaintiffs. In addition, Ruffa's option gave him a sufficient motive to conceal his knowledge in order to cash in on his investment. Accordingly, since Ruffa was a senior partner of R & H, it may be inferred that his partner, Hanover, had knowledge of the fraudulent scheme, and that knowledge is imputed to their law firm, R & H.³¹⁹

Insider status and financial motive, of course, may be intertwined,

316. Sommer, *The Emerging Responsibilities of the Securities Lawyer*, reprinted in D. RATNER & T. HAZEN, *SECURITIES REGULATION* 530-31 (4th ed. 1991).

317. *Pinter v. Dahl*, 486 U.S. 622, 651 (1988) (expressing concern that a liberal reading of § 12 of the Securities Act of 1933 “might expose securities professionals, such as accountants and lawyers, whose involvement is only the performance of their professional services, to § 12(1) strict liability”); *Capri v. Murphy*, 856 F.2d 473 (2d Cir. 1988) (lawyers functioned as insiders); *In re Professional Fin. Management, Ltd.*, 692 F. Supp. 1057 (D. Minn. 1988) (insider involvement by lawyer).

318. 1990 WL 6549 (S.D.N.Y. Jan. 23, 1990) (WESTLAW).

319. *Id.* at 5.

as indeed they were in *Shumate*. This is exemplified by a district court's decision in *In re Rospatch Securities Litigation*.³²⁰ The court upheld scienter allegations in a securities fraud case against a company's law firm and its managing partner, who was also a company director. The court pointed to four factors providing an inference of scienter: (1) the company was one of the firm's major clients; (2) as a director, the law firm's managing partner had a direct interest in keeping the price of the client's stock high; (3) the firm had handled all of the transactions attacked as improper;³²¹ and (4) the law firm allegedly manipulated its client's business relations to generate business for the law firm.³²² On the other hand, it will be recalled that the Weinberg & Green firm in *Schatz v. Rosenberg* allegedly had its fingerprints all over the fraudulent deal's paperwork and allegedly was paid from the proceeds of the fraud, but, nonetheless, the Fourth Circuit held that under no set of circumstances could the victims even allege a cause of action against the firm.³²³

5. Any Unusual Aspects of the Transaction

Participation in a transaction of an unusual nature ought to put the professional on guard.³²⁴ A jury should be allowed to draw an adverse inference against a professional who fails to exercise special cir-

320. 760 F. Supp. 1239 (W.D. Mich. 1991).

321. The court cited *In re Citisource, Inc. Sec. Litig.*, 694 F. Supp. 1069, 1083 (S.D.N.Y. 1988), for the proposition that the degree of a law firm's involvement as issuer's counsel in a fraudulent securities issue might warrant an inference of scienter. *Rospatch*, 760 F. Supp. at 1253.

322. *Rospatch*, 760 F. Supp. at 1253.

323. See *supra* notes 97-109 and accompanying text.

324. See, e.g., *United States v. Nicholson*, 677 F.2d 706, 710-11 (9th Cir. 1982) (proceeding with transaction in the face of highly suspicious circumstances provides a basis for invocation of a deliberate ignorance instruction). When the opinion or forecast is based on underlying materials which on their face or under the circumstances suggest that they cannot be relied on without further inquiry, then the failure to investigate further may "support an inference that when [the defendant] expressed the opinion it had no genuine belief that it had the information on which it could predicate that opinion." *Eisenberg v. Gagnon*, 766 F.2d 770, 776 (3d Cir.), *cert. denied*, 474 U.S. 946 (1985).

In reversing a jury finding of aider and abettor liability on the part of counsel for the underwriters in *Abell v. Potomac Ins. Co.*, 858 F.2d 1104 (5th Cir. 1988), *cert. denied*, 492 U.S. 918 (1989), the circuit court took into account that the firm provided "only legal services that '[constitute] the daily grist of the mill' of a law firm with a substantial securities practice." *Id.* at 1128 (citing *Woodward v. Metro Bank*, 522 F.2d 84, 97 (5th Cir. 1975)). The implication is that the lawyers were entitled to be more lax in handling what was for them a routine transaction. A less protective court could have used the fact that the defendant lawyers had a "substantial securities practice," as a negative feature. Specialists, after all, are held to a higher standard of care than those who lack special skills. See, e.g., RESTATEMENT (SECOND) OF AGENCY § 379 (1957).

cumspection in the face of facts reflecting grave risk. The Sixth Circuit has stated: "If the alleged aider and abettor conducts what appears to be a transaction in the ordinary course of his business, more evidence of his complicity is essential.' . . . Conversely, if the alleged aider and abettor conducts a transaction of an extraordinary nature, less evidence of his complicity is necessary."³²⁵ A failure to exercise increased diligence in the face of warning signs evidences connivance.³²⁶ The Tenth Circuit pointed this out when it observed:

When someone knows enough to put him on inquiry, he knows much. If a person with a lurking suspicion goes on as before and avoids further knowledge, this may support an inference that he has deduced the truth and is simply trying to avoid giving the appearance (and incurring the consequences) of knowledge.³²⁷

Thus, in *United States v. Simon*³²⁸ accountants were convicted for giving a fraudulent opinion when, at the very outset of their audit, they were aware that the client's daily check float was enormous, the client's comptroller was juggling cash, and a suspicious intercompany receivable had ballooned to huge size. The accountant who reported these alarming details had added, "all in all, it promises to be an 'interesting' audit."³²⁹

325. *SEC v. Washington County Util. Dist.*, 676 F.2d 218, 226 (6th Cir. 1982) (quoting *Woodward v. Metro Bank*, 522 F.2d 84, 95 (5th Cir. 1975)) (discussing the "general awareness" element of Rule 10(b)-5 aiding and abetting liability). See also *Pinter v. Dahl*, 486 U.S. 622, 651 (1988) (expressing concern that a too-liberal reading of § 12 under the Securities Act of 1933 "might expose securities professionals, such as accountants and lawyers, whose involvement is only the performance of their professional services, to § 12(1) strict liability"); *Woodward v. Metro Bank*, 522 F.2d 84, 97 (5th Cir. 1975) ("if the method or transaction is atypical or lacks business justification, it may be possible to infer the knowledge necessary for aiding and abetting liability").

326. See *Robinson v. Jacksonville Shipyards, Inc.*, 760 F. Supp. 1486, 1530 n.10 (M.D. Fla. 1991) ("If a person with a lurking suspicion goes on as before and avoids further knowledge, this may support an inference that he has deduced the truth and is trying simply to avoid giving the appearance, and incurring the consequences, of knowledge."). Warning signs need to be appreciated. In *Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1125 (9th Cir. 1985), *cert. denied*, 492 U.S. 918 (1989), the Fifth Circuit generously protected a securities firm that recklessly participated in a securities fraud, noting "plaintiffs must prove more than that the abettor recklessly ignored danger signals." Professionals should not count on always receiving insulation from accountability, however, when the risk of assisting impropriety is palpable. After all, MODEL PENAL CODE § 2.02(7) (1985) presents a generally accepted knowledge definition that provides that knowledge of a particular fact "is established if a person is aware of a high probability of its existence, unless he actually believes it does not exist." A professional who ignores the danger signals of a fraudulent scheme's existence is asking for trouble.

327. *United States v. De Francisco-Lopez*, 939 F.2d 1405, 1409 (10th Cir. 1991).

328. 425 F.2d 796, 809 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970).

329. *Id.* at 802. It will be recalled that in two cases when courts convicted account-

Another case on point is *SEC v. Martin*.³³⁰ There, the SEC fleshed out its stance on what lawyers must do upon receipt of notice of wrongdoing. In that case the Commission obtained a consent order against a lawyer who had prepared six tax opinions that were included in offering materials. The lawyer also had reviewed and edited the offering materials and responded to investors' questions. The lawyer was charged with ignoring what the Commission called "red flags." According to the SEC, the red flags, such as notice that the client-issuer's offices were unoccupied, "should have caused Martin to require further information from the promoters or, failing to acquire the requested information . . . to withdraw his participation from the offering, and correct his previous misrepresentations."³³¹

Similarly, in its recent ruling in *Breard v. Sachnoff & Weaver, Ltd.*,³³² the Second Circuit emphasized to the bar that business lawyers are to deal carefully with unusual facts that crop up in processing a transaction. Ignoring or down-playing facts that ought to excite inquiry, such as that a key participant in the deal was just indicted or convicted for fraud and conspiracy, is a recipe for disaster.

6. Evidence of "Conscious Avoidance" by the Professional of Direct Involvement in Wrongdoing

Lawyers called on to plead and prove scienter in civil suits against professionals can learn much by studying the burgeoning conscious avoidance precedent being developed in criminal cases. Indeed, the foreseeable, and foreseen,³³³ migration of conscious avoidance theory to the civil dockets already has begun. In *Chanel, Inc. v. Italian Ac-*

ants of criminal fraud, *United States v. Weiner*, 578 F.2d 757 (9th Cir.), *cert. denied*, 439 U.S. 981 (1978), and *United States v. Natelli*, 527 F.2d 311, 319 (2d Cir. 1975), *cert. denied*, 425 U.S. 934 (1976), the appellate courts directly referred to the important investigatory role inadequately discharged by the convicted auditors. *See supra* notes 266-69 and accompanying text.

330. [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,509 (D.D.C. 1983).

331. *Id.* ¶ 96,950. The unpleasantness at Salomon Brothers provides a current example of how inaction in the face of warning signs may be taken as evidence of complicity:

Even if [Salomon's Messrs. Gutfeund and Strauss] somehow succeeded in turning a blind eye to all five of the auctions in which Salomon has admitted wrongdoing, they could hardly have failed to notice the larger-than-legal holdings on the Salomon balance sheets. And if they knew, as they have admitted, of a single violation in April, how did they permit the occurrence of another, larger violation in May?

Lewis, *A Liar's Obituary*, Wall St. J., Aug. 21, 1991, at A12, cols. 3-4.

332. 941 F.2d 142 (2d Cir. 1991).

333. *See Mathews, Shifting the Burden of Losses in the Securities Markets: The Role of Civil RICO in Securities Litigation*, 65 NOTRE DAME L. REV. 896, 953 (1990).

tivewear of Florida, Inc.,³³⁴ the Eleventh Circuit held that "willful blindness" can provide the requisite intent or bad faith needed in a civil treble damage trademark infringement action.

Stock fraud litigation likewise provides another fertile field for using conscious avoidance theory. Judge Haight of the Southern District of New York recently observed in *SEC v. Musella*,³³⁵ a civil securities enforcement action: "I cannot accept that conscious avoidance of knowledge defeats scienter in a stock fraud case any more than it does in the typical *mens rea* criminal context. To hold otherwise would subvert the laws against fraudulent trading in securities."³³⁶ *Musella's* embrace of conscious avoidance has been emulated in a private action.³³⁷

Proof of scienter through inference drawn from conscious avoidance is a tactic ideally suited to business fraud cases brought against financiers, lawyers, and accountants.³³⁸ Their education, training, and experience all militate in favor of the jury's finding that the defendant professionals well understood what was going on. This was discussed by the First Circuit recently in a prosecution for violations of environmental laws:

"[T]here are many cases where from the actor's special situation and continuity of conduct an inference that he did know the untruth of what he said . . . may legitimately be drawn." This is more particularly allowable when the actors or utterers are persons in a far better position to judge than the unsophisticated public This concept has been consistently applied in federal courts.

We agree . . . that knowledge may be inferred from circumstantial evidence, including position and responsibility of defendants . . . as well as information provided to those defendants on prior occasions. Further willful blindness to the facts constituting the offense may be sufficient to establish knowledge.³³⁹

The established propriety of conscious avoidance instructions in criminal conspiracy cases to establish knowledge of the conspiracy's fraudulent goals³⁴⁰ validates its use in civil cases to establish the alleged wrongdoer's knowledge of the existence of a fraudulent scheme or a

334. 931 F.2d 1472 (11th Cir. 1991).

335. 678 F. Supp. 1060 (S.D.N.Y. 1988).

336. *Id.* at 1063.

337. See *Landau v. Vallen*, 1990 WL 91777 (S.D.N.Y. June 25, 1990) (WESTLAW).

338. See *supra* notes 259-94 and accompanying text.

339. *United States v. MacDonald & Watson Waste Oil Co.*, 933 F.2d 35, 54-55 & n.19 (1st Cir. 1990) (citations omitted) (quoting *United States v. Avant*, 275 F.2d 650, 653 (D.C. Cir. 1960)).

340. See, e.g., *United States v. Fletcher*, 928 F.2d 495, 502 (2d Cir. 1991). A conscious avoidance charge is not proper to establish knowing and intentional participation in the conspiracy, however. *Id.*

pattern of racketeering activity.³⁴¹

Plaintiffs' lawyers have several reasons for enthusiastically embracing use of conscious avoidance allegations and precedent in civil business fraud actions against professionals. First, convincing courts to use criminal conscious avoidance cases or Model Penal Code formulations as patterns for instructions in civil fraud cases should be relatively easy, since a legal formulation of culpability sufficient to send a wrongdoer to prison ought to suffice to prove the same issue in a civil damage case brought by the miscreant's victims.³⁴² Second, conscious avoidance theory allows the emphasis to be placed where it belongs—on facts and the inferences to be drawn from them, not on labels. Third, it protects against the possibility the case will be lost because of the court's refusal to accept recklessness as equivalent to intent or knowledge. Conscious avoidance theory permits the plaintiff to argue that the defendant in a fraud case could not have had a genuine belief that he or she was acting properly.³⁴³ Fourth, from a tactical standpoint, the professional is likely to have a hard time rebutting an inference of knowledge. The jury is apt to be skeptical of protestations of ignorance coming from well-schooled, well-paid, experienced professionals. Finally, a conscious avoidance instruction permits the plaintiff to appeal to the jury's common-sense, everyday understanding of life.

341. Thus, in *United States v. Massa*, 740 F.2d 629 (8th Cir. 1984), *cert. denied*, 471 U.S. 1115 (1985), a conscious avoidance instruction was used to establish knowledge of a conspiracy in a securities prosecution brought against brokerage firm employees. The court did not require proof the employees had detailed knowledge of the underlying facts. *Id.* at 642. In *United States v. Herrero*, 893 F.2d 1512 (7th Cir.), *cert. denied*, 110 S. Ct. 2623 (1990), a conscious avoidance instruction was upheld in an appeal of a lawyer who was convicted of conspiracy for participating in money laundering activities for a drug kingpin. And in *United States v. Deveau*, 734 F.2d 1023 (5th Cir. 1984), *cert. denied*, 469 U.S. 1158 (1985), a willful blindness instruction was used to convict a lawyer who participated, as an investor, in a securities fraud prosecution built around a corporate looting.

342. The Model Penal Code's drafters contemplated that its provisions would be used to shape jury instructions. The Code's willful blindness provision, § 2.02(7), was drafted specifically so it "clarifies the terms in which the issue [of knowledge] is submitted to the jury." MODEL PENAL CODE § 2.02 comment 9, at 248 (1985). Discussing recklessness, for example, the Code's commentary makes clear the intent that the provisions should be adapted for jury instructions: "The Code proposes . . . that the jury be asked to measure the substantiality and unjustifiability of the risk by asking whether its disregard, given the actor's perceptions, involved a gross deviation from the standard of conduct that a law-abiding person in the actor's position would observe." *Id.* comment 3, at 237.

343. Indeed, it is the defendant's own knowledge or the waywardness of his personal conduct that lies at the core of scienter. *E.g.*, Prosser & Keeton, *supra* note 13, § 107, at 742 ("A defendant who asserts a fact as of his own knowledge . . . when he knows that he does not in fact know whether what he says is true, is found to have the intent to deceive . . .").

The defendant's destruction of a document, premature departure from a meeting, or announcement that, "I do not want to hear about it," are events to which the jury may attach much meaning in the face of a conscious avoidance instruction. That instruction is an open invitation for the jury to evaluate the defendant's conduct based on what was there to be seen, in the context in which the defendant saw it.

V. CONCLUSION

Professionals are not usually front-line troops in the execution of swindles. They tend to operate on the periphery or in the background, quietly providing their essential assistance, usually out of public view. Civil courts have shown a tendency recently to be solicitous of professionals' interests. Some courts are inclined to change both the substantive elements of wrongs and the applicable pleading requirements in order to protect even reckless professionals from civil suits. No court has explained precisely what valid public interest is served by protecting irresponsible and reckless professionals from those proximately injured by fraudulent schemes. Contemporaneously with this move toward white collar protectiveness on the civil side, courts have moved in the direction of pro-prosecutor liberality on the criminal side. In criminal cases, the principle of "conscious avoidance" has come into its own as a flexible, highly useful means to prove criminal intent.

Though definition of culpability requirements is distinctly a legislative prerogative, Congress has shown only slight interest in attempting to reconcile the terms actual knowledge, deliberate ignorance, or recklessness when defining civil wrongs.³⁴⁴ Absent legislative leadership

344. In creating civil liability under the federal "Qui Tam" Statute, Congress equated actual knowledge with recklessness and deliberate ignorance:

[T]he terms "knowing" and "knowingly" mean that a person, with respect to information—

- (1) has actual knowledge of the information;
- (2) acts in deliberate ignorance of the truth or falsity of the information;
- or
- (3) acts in reckless disregard of the truth or falsity of the information,

and no proof of specific intent to defraud is required.

31 U.S.C. § 3729(b) (1988).

Likewise, government agencies may, through their rule-making powers, define key culpability terms. For example, the Bureau of Land Management's regulations covering proposals for non-Federal use of public lands provides:

"*Knowing and willful*" means that a violation is "*knowingly and willfully*" committed if it constitutes the voluntary or conscious performance of an act which is prohibited or the voluntary or conscious failure to perform an act or duty that is required. The term does not include performances or failures to perform which are honest mistakes or which are merely inadvertent. The term includes, but does not require, performances or failures to perform which re-

or regulators' willingness to draft coherent and consistent statutes or regulations, lawyers are left to navigate based on logic and analogy, and courts are left free to make political choices. Based on existing precedents, courts seem more willing to find the requisite scienter in cases brought on the criminal side, particularly when drug cartel members are defendants. Professional defendants in civil cases have been treated with considerable deference in some circuits. The same federal judiciary that is prone to impose or affirm Rule 11 financial sanctions on lawyers who negligently prepare papers filed in legal proceedings has become strikingly blasé about the accountability of lawyers who further their clients' financial frauds through conduct that is at best reckless. Some federal judges plainly are willing to tolerate lawyers negligently or recklessly papering deals, so long as they, the judges, are not the ones getting papered.

The cases demonstrate that lawyers in civil fraud cases can learn much by studying the Model Penal Code's culpability standards and criminal conscious avoidance precedent. The Model Penal Code's definitions, the conscious avoidance situation confronted in the Code's knowledge definition,³⁴⁵ and language from jury instructions approved in criminal conscious avoidance cases are readily adaptable to civil jury instructions. These precedents from the criminal field will create problems for the defense in civil cases brought against professionals. Defendants in those cases will have a difficult time articulating how legal principles embodied in a set of jury instructions that could lead to jail time in a criminal fraud case can be unfairly harsh to the defense in a civil damage suit.

Though it is improper to use a conscious avoidance instruction ab-

sult from a criminal or evil intent or from a specific intent to violate the law. The knowing or willful nature of conduct may be established by plain indifference to or reckless disregard of the requirements of law, regulations, orders, or terms of a lease. A consistent pattern of performance or failure to perform also may be sufficient to establish the knowing or willful nature of the conduct, where such consistent pattern is neither the result of honest mistake or mere inadvertency. Conduct which is otherwise regarded as being knowing or willful is rendered neither accidental nor mitigated in character by the belief that the conduct is reasonable or legal.

43 C.F.R. § 2920.0-5(m) (1990). Of course, there is a difference between having a definition, and having a definition that makes sense. In comparison with the Qui Tam Statute, the regulation represents inferior drafting. The regulation holds that knowing conduct can be established by "plain indifference." This reaches negligent conduct, despite the claim that neither "honest" nor "inadvertent" mistakes are covered. If negligent conduct was not meant to be covered, the adjectives "deliberate" or "conscious" should have been used to modify "indifference." The protection the regulation gives "honest mistakes" is further undermined in the regulation's last sentence.

345. See MODEL PENAL CODE § 2.02(7) (1985); MODEL PENAL CODE & COMMENTARIES § 2.02, explanatory note 9, at 248 (1985).

sent evidence of conduct that translates into conscious avoidance of the truth,³⁴⁶ in many cases the professional's sophistication, access to data, and critical role in furthering the fraudulent enterprise will combine to provide a powerful inference of scienter. Quite simply, proof of the professional's conscious avoidance of knowledge offers an ideal way to prove guilty knowledge in many white collar cases that call for proof of scienter.

Conversely, criminal lawyers eager for helpful precedent should pay close attention to the pro-defense trend emerging in federal common-law cases under 10b-5. If immunity from civil liability under the securities laws is deserved by reckless lawyers and accountants, then why not immunity from criminal liability as well? If fraudulent professionals are immune from prosecution in 10b-5 civil cases on policy grounds, can those same fraudulent acts be criminal? And why should the immunity stop at the limits of the securities laws? Why should not professionals who knowingly or recklessly further their clients' frauds also enjoy immunity from liability under the mail fraud, wire fraud, and false statement statutes? Are our federal courts on their way to granting blanket immunity across all of criminal law to professionals whose conduct is reckless or worse?³⁴⁷

It is fair to wonder whether the sort of favoritism toward professionals evidenced so clearly by *Schatz v. Rosenberg* opens up an equal protection problem. All other things being equal, why should a lay person who does the same sort of thing as a lawyer to further a fraud face civil or criminal liability when the lawyer would not? Skeptics are left free to wonder how investor confidence is bolstered when courts condone truly egregious behavior by professionals who, in reality, serve as the only check on fraudulent managements. Those managements, once sued or indicted, can be counted on to try to hide behind their professional helpers, claiming good faith and professing that they were relying on the lawyers and accountants who papered the deal to speak up if something was wrong. Are we not witnessing an erosion of standards

346. See, e.g., *United States v. Manriquez Arbizu*, 833 F.2d 244, 249 (10th Cir. 1987); *United States v. Murrieta-Bejarano*, 552 F.2d 1323, 1325 (9th Cir. 1977).

347. Fourth Circuit precedent indicates that the scienter standard in civil cases against professionals is higher than in criminal cases (at least when the criminal defendant is a nonprofessional). In *Schatz*, the Fourth Circuit demanded that the plaintiff establish that the lawyers' scienter equaled a "high conscious intent," coupled with a "conscious and specific motivation" to aid the fraud. *Schatz v. Rosenberg*, 943 F.2d 485, 496 (1991). In *United States v. Hester*, 880 F.2d 800 (4th Cir. 1989), however, the court affirmed a criminal conviction on a false statement charge based on a jury instruction that equated criminal scienter with making a statement with a "deliberate disregard for its truth or falsity with a conscious purpose to avoid learning the truth." *Id.* at 802. The criminal scienter standard established by *Hester* seems more easily met than the civil test set forth in *Schatz*.

governing professional behavior in an era in which movement in the opposite direction is more appropriate?